Effective date May 1996

INTRODUCTION

To meet competitive pressures, banks provide a large number of customer services that normally do not result in assets and liabilities subject to entry on the general ledger, but that may involve significant risk. These customer services include fiduciary accounts, investment management, customer safekeeping, rental of safe deposit box facilities, purchase and sale of investments for customers, sale of traveler's checks, and collection department services. The bank is responsible for properly maintaining and safeguarding all consigned items. Banks accomplish the necessary control and review of consigned and collection items through non-ledger control or memorandum accounts. Automated systems, such as a Securities Movements Accounting and Control system (SMAC), can provide proper control for fiduciary, customer safekeeping, custodial, and investment management accounts.

CUSTOMER SAFEKEEPING

Custodial and Investment Management Accounts

Banks may act as custodians for customers' investments such as stocks, bonds, or gold. Custodial responsibilities may involve simple physical storage of the investments, as well as recording sales, purchases, dividends, and interest. On the other hand, responsibilities may be expanded to include actually managing the account. This type of account management includes advising customers when to sell or buy certain investments, as well as meeting their recording requirements. In addition, the bank may lend securities from custodial accounts if authorized by the customer. This transaction allows the bank, as custodian, to charge a fee for lending the securities, thereby reducing its net custody costs. Also, both the bank and the custodial account benefit from interest earned on the transaction. This type of transaction should be governed by a policy that clearly specifies quality and maturity parameters. Additionally, to prevent defaults, borrowers should be subject to minimum credit standards, ongoing financial monitoring, and aggregate borrowing limits. Banks may also indemnify customer accounts against losses from a borrower or collateral default. Such indemnification creates a contingent financial risk to the institution.

Before providing such management and/or lending services, the bank should seek the advice of legal counsel about applicable state and federal laws concerning that type of bankcustomer relationship. In addition, the use of signed agreements or contracts that clearly define the services to be performed by the bank is a vitally important first step in limiting the bank's potential liability and risk. The bank must also ensure that a proper control environment, including joint custody and access procedures, is established and maintained in support of custodial and management activities. Clearly, the largest and most active companies take on an increased level of risk. For companies that are aggressively pursuing custodial services or other nontraditional lines of business, the examiner should consider an expanded scope of review for these activities.

Safe Deposit Boxes

When banks maintain safe deposit box facilities, the bank and the customer enter into a contract whereby the bank receives a fee for renting safe deposit boxes. The bank assumes the responsibility of exercising reasonable care and precaution against loss of the box's contents. When a loss does occur, unless the bank can demonstrate it has maintained the required standard of care, it could be held liable for the loss. The required standard of care is defined as that which would be taken by a reasonably prudent and careful person engaged in the same business. Two different keys are required to open the box, and the customer and the bank each have one. Careful verification of a customer's identification is critical to meeting an appropriate standard of care. The customer is not required to disclose the contents of the box to the bank and

^{1.} Collection of interest and dividend income cannot be facilitated by the bank where the securities held are still in the customer's name, unless the paying agent is advised to change the dividend/interest address. Typically, when securities remain in the registered name of the holder, the holder continues to receive the dividend/interest payments. If the securities are re-registered into the name of the bank (or its nominee), then dividends and interest are received by the bank for the credit of the custodial customer.

upon court order the bank may gain access to the box without the presence of the customer.

Safekeeping

In addition to items held as collateral for loans, banks occasionally hold customers' valuables for short periods of time. The bank may or may not charge a fee for the service. Although it is a convenience for bank customers, many banks attempt to discourage the practice by emphasizing the benefits of a safe deposit box. When it is not possible or practical to discourage a customer, the same procedures that are employed in handling collateral must be followed. Items to be stored should be inventoried by two persons and maintained under dual control in the bank's vault. A multicopy, prenumbered, safekeeping receipt should be prepared with a detailed description of the items accepted and it should be signed by the customer. Sealed packages with contents unknown to the bank should never be accepted for safekeeping.

COLLECTION ITEMS

The collection department is one of the most diversified areas in the bank. It engages in receiving, collecting, and liquidating items which generally require special handling and for which credit normally is given only after final payment is received. The bank acts as agent for its customers or correspondents and receives a fee for that service. Even though general ledger accounts rarely are used in the collection process, the importance and value of customer assets under bank control demand the use of accounting procedures adequate to provide a step-by-step historical summary of each item processed. An audit trail must be developed to substantiate the proper handling of all items and to reduce the bank's potential liability.

CONSIGNED ITEMS

The most common items held on consignment by banks are unissued traveler's checks and gold. Traveler's checks have gained widespread popularity because of the possibility that customers can obtain a refund if the checks are lost or stolen. Traveler's checks are issued for a fee or commission shared by the consignor and the issuing bank. Generally, a working supply of the checks is maintained at the teller line or selling station and a reserve supply is maintained under dual control in the bank's yault.

Under paragraph 7 of section 5136 of the Revised Statutes, national banks may exercise their powers "by buying and selling exchange, coin and bullion." This statute is applied to state member banks under section 9, paragraph 20, of the Federal Reserve Act. Consequently, banks may deal only in gold or silver that qualifies as coin or bullion. The term "coin" means coins minted by a government or exact restrikes, minted at a later date by, or under the authority of, the issuing government. The restrictions contained in the Glass-Steagall Act, which prohibit investment in or underwriting of securities, also are applicable to securities of companies involved with gold.

Rarely does a bank receive sufficient revenues from the above transactions to cover the cost of handling them. However, banks must offer a full range of services to be competitive and attract customers. The bank assumes the responsibility and related contingent liability to properly maintain the assets of others and to properly record all transactions involved with the consigned items.

INTERNAL CONTROL CONSIDERATIONS

It is essential that bank policy provides for proper internal controls, operating procedures, and safeguards. In all cases, control totals must be generated and the function balanced periodically by someone not associated with the function. Proper insurance protection must also be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. If an employee should, by fraud or negligence, permit unauthorized removal of items held for safekeeping or issue traveler's checks improperly, the bank may be held liable for losses. Therefore, banks should maintain adequate bonding for contingent liabilities and the examiner should review applicable insurance policies.

Other Non-Ledger Control Accounts Examination Objectives

Effective date May 1996

Section 4120.2

- To determine if the policies, practices, procedures, and internal controls regarding custodial activities, consigned items, and other non-ledger control accounts are adequate.
- To determine if bank officers and employees are operating in conformance with the established guidelines.
- 3. To determine the scope and adequacy of the audit function.
- 4. To determine compliance with laws and regulations.
- To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Other Non-Ledger Control Accounts

Examination Procedures

Effective date March 1984

Section 4120.3

- If selected for implementation, complete or update the Consigned Items and Other Non-Ledger Control Accounts section of the Internal Control Questionnaire.
- Based on the evaluation of internal controls and the work performed by internal/ external auditors, determine the scope of the examination.
- 3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control" and determine if appropriate corrections have been made.
- Obtain a listing of consigned items and other non-ledger control accounts from the bank.
- 5. Scan any existing control accounts for any

- significant fluctuations and determine the cause of fluctuations.
- Compare bank control records to remittance records for unissued U.S. savings bonds and food stamps.
- Determine compliance with laws and regulations pertaining to non-ledger control accounts by determining, through observation and discussion with management, that there exist no violation of the prohibition against a bank participating in lotteries (section 9A of the Federal Reserve Act (12 USC 25A)).
- 8. Prepare in appropriate report form, and discuss with appropriate officer(s):
 - a. Violations of laws and regulations.
 - b. Recommended corrective action when policies, practices or procedures are deficient.
- 9. Update the workpapers with any information that will facilitate future examinations.

Other Non-Ledger Control Accounts Internal Control Questionnaire

Effective date March 1984

Section 4120.4

Review the bank's internal controls, policies, practices and procedures for consigned items and other non-ledger items. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

SAFE DEPOSIT BOXES

- Has counsel reviewed and approved the lease contract in use which covers the rental, use and termination of safe deposit boxes?
- *2. Is a signed lease contract on file for each safe deposit box in use?
- 3. Are receipts for keys to the safe deposit box obtained?
- 4. Are officers or employees of the bank prohibited from acting as a deputy or having the right of access to safe deposit boxes except their own or one rented in the name of a member of their family?
- 5. Is the guard key to safe deposit boxes maintained under absolute bank control?
- 6. Does the bank refuse to hold, for renters, any safe deposit box keys?
- 7. Is each admittance slip signed in the presence of the safe deposit clerk and the time and date of entry noted?
- 8. Are admittance slips filed numerically?
- Are vault records noted for joint tenancies and co-rental contracts requiring the presence of two or more persons at each access?
- 10. Are the safe deposit boxes locked closed when permitting access and the renter's key removed and returned to the customer?
- 11. Is the safe deposit clerk prohibited from assisting the customer in looking through the contents of a box?
- 12. Does the safe deposit clerk witness the relocking of the box?
- 13. Are all coupon booths examined by an attendant after being used but before being assigned to another renter, to be sure the

- previous person did not leave behind anything of value?
- 14. Has a standard fee schedule for this service been adopted?
- 15. Are all collections of rental income recorded when received?
- 16. Are all safe deposit boxes where lessee is delinquent in rent, flagged or otherwise marked so that access will be withheld until rent is paid?
- 17. Is there a file maintained of all attachments, notices of bankruptcy, letters of guardianship and letters testamentary served on the bank?
- 18. Is an acknowledgment of receipt of all property, and a release of liability signed upon termination of occupancy?
- 19. Are locks changed when boxes are surrendered, whether or not keys are lost?
- 20. Is drilling of boxes witnessed by two individuals?
- 21. Are the contents of drilled boxes inventoried, packaged, and placed under dual control?
- *22. Are all extra locks and keys maintained under dual control?

Conclusion

- 23. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- 24. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

ITEMS IN SAFEKEEPING

- *25. Are such items segregated from bankowned assets and maintained under dual control?
- 26. Is there a set charge or schedule of charges for this service?

- 27. Do bank policies prohibit holding items in safekeeping free of charge?
- 28. Are duplicate receipts issued to customers for items deposited in safekeeping?
- 29. Are the receipts prenumbered?
- *30. Is a safekeeping register maintained to show details of all items for each customer?
- *31. Is a record maintained of all entries to custodial boxes or vaults?
- 32. Does the bank refuse to accept sealed packages when the contents are unknown?
- 33. If the bank has accepted sealed packages for safekeeping, the contents of which are not described, has the approval of the bank's counsel been obtained?
- 34. When safekeeping items are released, are receipts obtained from the customer?

Conclusion

- 35. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- 36. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

CUSTODIAN ACCOUNTS

(Omit this section if the bank's trust department handles such accounts).

- *37. Does the bank have written contracts on hand for each account that clearly define the functions to be performed by the bank?
 - 38. Has bank counsel reviewed and approved the type and content of the contracts being used?
- 39. Does the bank give customers duplicate receipts with detailed descriptions, including dates of coupons attached, if applicable, for all items accepted?
- 40. Are those receipts prenumbered?
- 41. Do bank procedures prohibit its holding any investments not covered by a sale or purchase order in this department?

- 42. Are all orders for the purchase and sale of investments properly authorized in the account contract or signed by customers?
- 43. For coupon securities held by the bank:
 - a. Is a tickler file or other similar system used to ensure prompt coupon redemption on accounts where the bank has been authorized to perform that service?
 - b. Are procedures in effect to prevent clipping of coupons where bank is not so authorized?
 - c. Have procedures been adopted to insure prompt customer credit when coupon proceeds or other payments are received?
- *44. Are all investment items handled in this area maintained under dual control?
- 45. Have procedures been established for withdrawal and transmittal of items to customers?
- *46. Does an officer review and approve all withdrawals prior to the transaction?
- 47. Has a standard fee schedule for this service been adopted?

Conclusion

- 48. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- 49. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

COLLECTION ITEMS

- 50. Is access to the collection area controlled (if so, indicate how)?
- *51. Are permanent registers kept for incoming and outgoing collection items?
 - 52. Are all collections indexed in the collection register?
- 53. Do such registers furnish a complete history of the origin and final disposition of each collection item?

- 54. Are receipts issued to customers for all items received for collection?
- 55. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
- *56. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collection items?
- 57. Is a record kept to show the various collection items which have been paid and credited as a part of the day's business?
- 58. Is an itemized daily summary made of all collection fees, showing collection numbers and amounts?
- 59. Are employees handling collection items periodically rotated, without advance notification, to other banking duties?
- *60. Is the employee handling collection items required to make settlement with the customer on the same business day that payment of the item is received?
- 61. Does the bank have an established policy of not allowing the customer credit until final payment is received?
- *62. Have procedures been established, including supervision by an officer, for sending tracers and inquiries on unpaid collection items in the hands of correspondents?
- 63. In the event of nonpayment of a collection item, is the customer notified and the item promptly returned?
- *64. Are the files of notes entered for collection clearly and distinctly segregated from bank-owned loans and discounts?
- *65. Are collection notes above maintained under memorandum control and is the control balanced regularly?
- 66. Are collection files locked when the employee handling such items is absent?
- 67. Are vault storage facilities provided for collection items carried over to the next day's business?
- *68. Does the collection teller turn over all cash to the paying teller at the close of business each day and start each day with a standard change fund?
- 69. Has a standard fee schedule for this service been adopted?
- 70. Is the fee schedule always followed?
- 71. Is a permanent record maintained for registered mailed?

Conclusion

- 72. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- 73. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

CONSIGNED ITEMS

- *74. Is the reserve stock of consigned items maintained under dual control?
- 75. Are working supplies kept to a reasonable minimum, i.e., two or three days' supply, and adequately protected during banking hours?
- *76. Is a memorandum control maintained of consigned items?
- 77. Are separate accounts with the consignor maintained at each issuing location (branch), if applicable?
- *78. Is the working supply put in the vault at night and over weekends or holidays or is it otherwise protected?
- 79. Are remittances for sales made on a regularly scheduled basis, if not daily?

Conclusion

- 80. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- 81. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

Modern economies require an efficient system for transferring funds between financial institutions and between financial institutions and their customers. Banks and other depository institutions use payment systems both to transfer funds related to their own operations—for example, when engaging in federal-funds transactionsand to transfer funds on behalf of their customers. Banks and the Federal Reserve together provide the basic infrastructure for our nation's payments system.

Commercial banks maintain accounts with each other and with the Federal Reserve, through which the payments of the general public are recorded and ultimately settled. The demand for electronic funds transfer (EFT) has increased with improved data communication and computer technology. Community banks that previously executed EFT transactions through a correspondent can now initiate their own same-day settlement transactions nationwide. The need for same-day settlement transactions (that is, no float time) has precipitated financial institutions' increased reliance on EFT systems. Financial institutions commonly use their EFT operations to make and receive payments, buy and sell securities, and transmit payment instructions to correspondent banks worldwide. In the United States, most of the dollar value of all funds transfers is concentrated in two electronic payments systems: Fedwire, which is a Federal Reserve service, and the Clearing House Interbank Payments System (CHIPS), which is a private settlement system owned and operated by the New York Clearing House Association. The flow of funds through these systems is extremely large compared to the reserve and clearing-account balances maintained the financial institutions participating in the systems.

The efficiency of a payments system depends, to a large extent, on the certainty of settlement of payments. Final settlement occurs when payment obligations between payments system participants are extinguished with final and irrevocable funds. In cash-transaction payments, payment and settlement occur simultaneously. On occasion, settlement may not occur on the same day. Without settlement, the recipient of a payment faces the uncertainty of not receiving the value of funds that has been promised. The exposure to this uncertainty is generally referred to as payments system risk. The examiner's role is to ensure that banks effectively monitor and control their exposure to this risk.

The amount and, subsequently, the velocity of funds transfers that must be settled expose a bank to many types of specific risk under the general category of payments system risk. In particular, there is liquidity risk, which is the risk that a counterparty may be temporarily unable to cover its obligation to the bank at the time settlement is supposed to occur. There is also credit risk, which is the risk that another participant in the payments system will fail to settle at the end of the day. The provision of intraday credit (often referred to as daylight overdrafts or daylight credit) exposes participants to payments system risk because the provider of the credit may be unable to collect final funds from the receiver at the time payment is due or at all. On those occasions when payments are not settled on the same day, daylight overdrafts may result in overnight (or interday) overdrafts.

A daylight overdraft occurs whenever the balance in an institution's account shows a deficit during the business day. Such a credit exposure can occur in an account that an institution maintains with a Federal Reserve Bank or with a private-sector financial institution. A daylight overdraft occurs at a Reserve Bank when an institution has insufficient funds in its Federal Reserve account to cover outgoing funds transfers or incoming book-entry securities transfers or as a result of other payment activity processed by the Reserve Bank, such as checkclearing transactions.

For purposes of measuring daylight overdrafts in Federal Reserve accounts, the Federal Reserve uses a special accounting methodology for posting debits and credits that result from various transactions. Fedwire funds and securities transfers are posted to an institution's account as they occur. Other transactions processed by Reserve Banks are posted at specified times during the day. The account balance is measured at the end of each minute during the business day; the end-of-minute balances are used by Reserve Banks for determining compliance with net debit caps and for calculating daylight overdraft fees. The net debit cap is the maximum dollar amount of daylight overdrafts an institution is permitted to incur in its Federal Reserve account at any point in the day or on average over a two-week period.

TYPES OF PAYMENTS SYSTEMS

The many thousands of payments that bank customers make each day result in transfers of balances among banks and between banks and Reserve Banks. In addition, banks make their own payments in connection with carrying out the business of banking. Banks can make interbank payments through accounts that they hold with a correspondent bank. However, many interbank payments, especially large-dollar payments, are made through the transfer of balances on the books of the Federal Reserve Banks.

To evaluate the operational procedures used by depository institutions to control paymentprocessing risks for their own accounts or for their customers' accounts, it is necessary to understand the mechanics of the various payments systems. The purpose of this summary is to discuss the operations of a range of payment services and to explain some of the associated risks banks are subject to.

Electronic Funds Transfer Systems

Fedwire

The Federal Reserve System operates a national funds-transfer system, Fedwire, and acts as a clearinghouse for transactions executed over the system. Fedwire provides for the electronic transfer of immediate and irrevocable payments between participating institutions and functions as both a clearing and settlement facility for funds and securities transfers, which average more than \$1 trillion per day.

The Fedwire funds-transfer system is a realtime, gross-settlement, credit-transfer system. Each funds transfer is settled individually on the books of the appropriate Federal Reserve Bank as it is processed and is considered a final and irrevocable payment. A depository institution that sends a funds transfer irrevocably authorizes its Reserve Bank to charge its account for the transferred amount and further authorizes the Reserve Bank of the receiving institution to transfer the same amount to the account of the receiving institution. The Federal Reserve guarantees immediate availability of funds. Once the Federal Reserve Bank credits the receiving institution's account or delivers the advice of payment, the Federal Reserve Bank will not reverse credit for the payment. Therefore, there is no settlement risk to the recipient of a Fedwire transfer. The Federal Reserve Bank assumes the risk if the sending bank does not settle its position at the Reserve Bank at the end of the business day. This means that the Federal Reserve may be at risk for daylight overdraft credit extended when it credits the account of the receiving institution for an amount in excess of the actual intraday balance in the account of the sending institution. The use of daylight overdrafts is not encouraged, and banks are subject to credit limits and specific charges set by the Federal Reserve. Furthermore, such daylight overdraft privileges can be revoked at any

Banks can access Fedwire in several ways. Many large banks' computer to computer links between the bank's computer facility and the Federal Reserve are over leased telephone lines. Lower volume users usually have dial-up access using microcomputers and Fedline software. Some users are off-line, requiring a separate call to the Federal Reserve for each transaction.

CHIPS

The Clearing House Interbank Payments System (CHIPS) is a funds-transfer network owned and operated by the New York Clearing House Association (NYCHA) to deliver and receive U.S. dollar payments between domestic or foreign banks that have offices located in New York City. The network consists of a small number of settling participants (large U.S.-chartered banks that settle end-of-day balances with each other) and a larger number of nonsettling participants who maintain accounts with one of the settling banks. Settling participants handle settlements for nonsettling participants. Although a large volume of CHIPS payments are for settlement of U.S.-dollar foreign-exchange contracts and Eurodollar investments, there are a significant number of domestic business-related transactions. The interbank settlement of payments will normally be completed by the end of the business day. Unlike Fedwire, a credit received through CHIPS may not be a final settlement and can be reversed later in the day. To avoid such reversals, CHIPS has a number of risk-management tools in place. Nonetheless, the receiving institution needs to recognize that it faces some level of intraday credit exposure through the sending institution (or its settling participant) until final settlement is achieved at the end of the business day.

CHIPS functions through computer terminals located on the premises of the participating institutions, which are linked by leased telephone lines with the central computer located at the New York Clearing House Association. In general, expenses incurred by the NYCHA to operate the system are assessed against all participants on the basis of the total number of messages processed.

Manual Systems

Not all financial institutions employ an electronic funds transfer system. Some banks execute such a small number of EFT transactions that the cost of a personal computer–based system such as Fedwire is prohibitive. Instead, these banks will continue to execute EFTs by a telephone call to a correspondent bank. Executing EFT transactions in this manner is an acceptable practice as long as the bank has adequate internal control procedures.

Message Systems

The message systems employed by financial institutions, corporations, or other organizations to originate payment orders-either for their own benefit or for payment to a third party—are indispensable components of funds-transfer activities. Unlike payments systems, which transmit actual debit and credit entries, message systems process administrative messages and instructions to move funds. The actual movement of the funds is then accomplished by initiating the actual entries to debit the originating customer's account and credit the beneficiary's account. If the beneficiary's account or the beneficiary bank's account is also with the originator's bank, the transaction is normally handled internally through "book entry." If the beneficiary-related accounts are outside the originating customer's bank, the transfer may be completed by use of a payments system such as Fedwire or CHIPS. The means of arranging payment orders ranges from manual methods (for example, memos, letters, telephone calls, fax messages, or standing instructions) to electronic methods using telecommunications networks. These networks may include those operated by the private sector, such as SWIFT or Telex, or other networks operated internally by particular financial institutions.

Even though the transfers initiated through systems such as SWIFT and Telex do not result in the immediate transfer of funds from the issuing bank, they do result in the issuing bank having an immediate liability, which is payable to the disbursing bank. Therefore, the operating controls of these systems should be as stringent as the ones implemented for systems such as Fedwire and CHIPS.

SWIFT

Society for Worldwide Interbank Financial Telecommunications (SWIFT) is a nonprofit cooperative of member banks serving as a worldwide interbank telecommunications network based in Brussels, Belgium. It is the primary system employed by financial institutions worldwide to transmit either domestic or international payment instructions.

TELEX

Several private telecommunications companies offer worldwide or interconnected services that provide a printed permanent record of each message transmitted. Telex is the primary message system for institutions that do not have access to SWIFT. The Telex systems do not include built-in security features. Telex users exchange security codes, and senders sequentially number messages sent to another institution.

FEDWIRE BOOK-ENTRY SECURITIES TRANSFERS

In general, a Fedwire book-entry security transfer is the electronic transfer of a U.S. Treasury or government-agency security as opposed to a physical transfer of a security. When book-

entry securities transfers are processed over Fedwire, the institution sending the transfer receives immediate credit in its Federal Reserve (funds) account for the payment associated with the transfer, and its securities account is correspondingly debited. The Federal Reserve (funds) account of the institution receiving the transfer is debited for the payment amount, and its securities account is credited. Because the institution sending the securities controls the timing of the transfer, it is often difficult for institutions receiving book-entry securities transfers to anticipate funding needs and, thus, to control daylight overdrafts. Therefore, depository institutions must understand the intraday flows associated with their customers' bookentry activity to have a good understanding of peak intraday funding needs.

PRIVATE BOOK-ENTRY SYSTEMS

In addition to U.S. Treasury and governmentagency securities, many other financial instruments are commonly traded in the United States. Corporate and municipal securities are traded through a national clearance and settlement network of four clearing corporations and three depositories. Clearing corporations provide trade comparison and multilateral netting of trade obligations. The vast majority of corporate equity and bond trades are cleared through the National Securities Clearing Corporation (NSCC). Depositories, in contrast, hold physical securities and provide book-entry transfer and settlement services for their members. Most corporate securities, as well as municipal government bonds, are held at the Depository Trust Company (DTC) in New York.

U.S. Treasury, federal-agency, and mortgagebacked securities are generally traded in overthe-counter markets. The Government Securities Clearing Corporation (GSCC) compares and nets its members' trades in most U.S. Treasury and federal-agency securities. The GSCC relies on the Fedwire book-entry securities-transfer system, discussed above, to effect final delivery of securities to its participants.

The Mortgage-Backed Securities Clearing Corporation, a subsidiary of the Midwest Stock Exchange, compares and nets trades in mortgagebacked securities. The resulting net obligations are settled either through the Fedwire bookentry securities system or the Participants Trust Company (PTC), a New York-based depository, depending on the securities involved.¹

AUTOMATED CLEARINGHOUSE AND CHECK TRANSACTIONS

Automated clearinghouse (ACH) transactions are batch-processed, value-dated electronic funds transfers that are used as a payment instrument primarily for recurring payments initiated by businesses and governments. Compared with check payments, ACH payments offer more certainty in the timing of payments, are more convenient to consumers, provide a greater level of security to the recipients of funds, and provide opportunities for greater efficiencies for banks. The level of risk involved in processing ACH payments depends on two factors: (1) the value of individual items being processed, as well as the total value of the ACH file, and (2) the type of ACH transaction, that is, whether it is a credit or a debit transaction.

Risk is not dependent on the individual transaction values alone, but on the value of the entire ACH file. For example, although the individual transaction value of corporate payments is usually larger than the value of individual direct deposit of payroll transactions, payroll files tend to have a far greater number of transactions and, therefore, their aggregate dollar value could be very large.

The second element that is crucial in the level and type of risks involved in the settlement of ACH payments is the type of ACH transaction. A file containing mortgage payments or insurance premiums could be an example of an ACH debit file. In this type of transaction, funds flow from the receiver to the originator of the transaction. ACH debit transactions are very similar in nature to check transactions. Both receivers of ACH debit files and payers of checks have the right to return transactions for various reasons, such as insufficient funds in the account or a closed account. The major risk facing institutions that originate ACH debit transactions and collect checks for customers is return-item risk. Return-item risk extends from the day funds are

^{1.} The Fedwire book-entry securities system settles mortgage-backed securities transactions in Federal National Mortgage Association (Fannie Mae) securities and Federal Home Loan Mortgage Corporation (Freddie Mac) securities. PTC settles mortgage-backed securities guaranteed by the Government National Mortgage Association and collateralized mortgage obligations of the Veterans Administration.

made available to the customer until the individual return items are received.

ACH credit transactions are similar to Fedwire funds transfers in that funds flow from the originator of the transaction to the receiver. A company payroll would be an example of an ACH credit transaction. In this type of transaction, the bank originating payments on behalf of a customer (the employer in this instance) has a binding commitment to make the payments to the ACH processor when the bank deposits its files with the ACH processor. Since the ACH is a value-dated mechanism, that is, transactions may be originated one or two days before the specified settlement day, the bank is exposed to temporal credit risk that can extend from one to three business days, depending on when the customer (the employer) funds the payments it originates. If the customer fails to fund the payments on the settlement day, the potential loss faced by the originating bank is equal to the total value of payments deposited with the processor from the time the payments are deposited until the customer funds these payments.

PAYMENTS SYSTEM RISK

Payments system activity gives rise to three forms of risk:

- Direct credit risk to the Federal Reserve is the
 possibility that an institution may be unable
 to cover its intraday overdraft arising from
 a transfer of funds or receipt of book-entry
 securities, which would cause the Federal
 Reserve Bank processing the payment to incur
 a loss.
- Private direct credit risk is the possibility of loss to institutions extending daylight credit through private settlement systems as the result of an institution being unable to cover its intraday debit position for reasons independent of developments in the payments system.
- Systemic risk is the possibility that the failure of one participant in a transfer system will cause other participants to fail to meet their obligations.

Risks to Reserve Banks

Federal Reserve Banks may be exposed to

payments system risk when they process payments for institutions that hold accounts with them. As previously mentioned, the Federal Reserve System guarantees payment on transactions made by accountholders over the Fedwire funds-transfer system. If an institution were to fail after sending a funds transfer that caused an overdraft in its account (a daylight overdraft), the Federal Reserve would be obligated to cover the payment and bear any resulting losses. Fedwire's finality rules limit the amount of systemic risk in the payments system. The total of depository institutions' peak daylight overdrafts in Federal Reserve accounts was approximately \$85 billion per day, on average, during

Although the Federal Reserve's exposure is significant and risk of loss is present even when an institution overdraws its account at a Reserve Bank for only a few minutes, the chance that the Federal Reserve will sustain a major loss is relatively small. Collateral is generally required for institutions with a history of daylight overdrafts or known problems. In addition, depository institutions (including foreign-related ones) are monitored on an ongoing, and in some cases, real-time basis by the Federal Reserve, and they are also closely supervised by federal and state regulatory agencies.

Private Direct Credit Risk and Systemic Risk

Similar to Reserve Banks, private-sector financial institutions and participants in private-party financial arrangements may be exposed to credit risk through the extension of intraday credit. One of the most significant dangers of private direct credit risk is that the failure of a borrower to cover its net debit position with a private creditor may impair the latter's ability to meet its own obligations to third parties. Further, the failure of even one major participant to meet its payments obligations in a private clearing arrangement could create a systemic disruption of the payments system or of financial markets in general. Such a major disruption has the potential to damage broader economic activity as well.

Because of the large number of transactions between depository institutions and the level of private daylight credit resulting from many of these transactions, financial positions change quickly and dramatically throughout the day. The failure of one depository institution may be difficult to isolate and, in principle, could induce a series of failures of interrelated creditors. In a financial crisis engendered by such insolvencies or associated illiquidities, other participants in financial markets could be adversely affected. Because systemic risk and other interdependent direct risks fall on third parties, these risks may not be completely recognized and managed.

SUPERVISORY POLICY OVERVIEW

A primary objective of examiners evaluating payments system risk (PSR) is to ensure that banks using Fedwire comply with the Board's PSR policy. In 1985, the Board of Governors of the Federal Reserve System adopted a policy to reduce the risks that large-dollar payments systems bring to the Federal Reserve Banks, the banking system, and other sectors of the economy. An integral component of the Federal Reserve's PSR policy is a program to control the use of intraday Federal Reserve credit.

The PSR policy further established limits, or caps, on the amount of Federal Reserve daylight credit that may be used by a depository institution during a single day and over a two-week period. These limits are sufficiently flexible to reflect the overall financial condition and operational capacity of each institution using Federal Reserve payment services. The policy also permits Reserve Banks to protect themselves from the risk of loss by requiring institutions to post collateral to cover daylight overdrafts in certain circumstances or by restricting the account activity of institutions that incur frequent or excessive overdrafts.

In 1992, the Board of Governors approved a policy that established fees to be assessed for institutions' use of Federal Reserve daylight credit beginning in April 1994. Along with the daylight overdraft fee policy, the Federal Reserve adopted a modified method of measuring daylight overdrafts that more closely reflects the timing of actual transactions affecting an institution's intraday Federal Reserve account balance. This measurement method incorporates specific account-posting times for different types of transactions.

The objective of daylight overdraft fees is to provide a financial incentive for institutions to control their use of intraday Federal Reserve credit and to recognize explicitly the risks inherent in the provision of intraday credit. Daylight overdraft fees induce institutions to make business decisions concerning the amount of intraday Federal Reserve credit they are willing to use based on the cost of using that credit. As a result, institutions should establish intraday credit limits for their customers that actively use payment services. The new daylight overdraft measurement method, which incorporates a set of transaction-posting rules for payments outside of Fedwire and the book-entry systems, should also help institutions control their use of Federal Reserve intraday credit by providing greater certainty about how their payment activity affects their Federal Reserve account balance during the day. Pursuant to the Federal Reserve Board's policy, daylight overdraft charges are calculated and assessed following each twoweek reserve-maintenance period. A more detailed explanation is contained in the Guide to the Federal Reserve's Payments System Risk Policy, which may be obtained from the risk management coordinator at any Reserve Bank.

NET DEBIT CAPS

Under the Federal Reserve's PSR program, each institution that maintains an account at a Federal Reserve Bank is assigned or may establish a net debit cap, which determines the amount of intraday Federal Reserve credit that the institution may use. An institution's net debit cap refers to the maximum dollar amount of uncollateralized daylight overdrafts that the institution may incur in its Federal Reserve account. Under the policy, financially healthy institutions may incur daylight overdrafts in their Federal Reserve accounts up to each institution's cap, provided that they have access to the Federal Reserve discount window. The net debit caps for institutions that may be considered "special situations"2 are discussed in detail at the end of this section.

The size of the institution's net debit cap is determined by its cap category and its reported capital. There are six cap categories: zero, exempt-from-filing, de minimis, average, above

Institutions considered special situations include U.S. branches and agencies of foreign banks, nonbank banks, industrial banks, institutions without access to the discount window, and institutions involved in interaffiliate transfer or third-party access arrangements.

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	Cap Multiples		
Cap Categories	Single day	Two-week average	
Zero	0	0	
Exempt-from-filing*	\$10 million/0.20	\$10 million/0.20	
De minimis	0.40	0.40	
Average	1.125	0.75	
Above average	1.875	1.125	
High	2.25	1.50	
111911	2.23	1.50	

^{*} The net debit cap for the exempt-from-filing category is equal to the *lesser* of \$10 million or 0.20 multiplied by risk-based capital.

average, and high. The last three categories are called self-assessment caps because they are established by an institution's own assessment of how it rates various financial performance factors, as described in greater detail below.

Each cap category is associated with cap multiples, which are shown in table 1. An institution's net debit cap, sometimes referred to as its daylight overdraft capacity, is calculated as its cap multiple times its amount of total risk-based capital:

Net debit cap = cap multiple
$$\times$$
 risk-based capital

An institution in the average, above-average, or high-cap category has two different cap multiples, one for its maximum allowable overdraft on any day ("single-day cap") and one for the maximum allowable average of its peak daily overdrafts in a two-week period ("two-week average cap"). Institutions in the zero, exempt-from-filing, and de minimis cap categories have a single cap that applies to both the single-day peak overdraft and the average peak overdraft for a two-week period.

An institution's cap category is normally fixed over a one-year period. The dollar amount of a net debit cap, on the other hand, is a function of an institution's capital and will vary over time as the institution's capital changes.

Cap Categories

An institution can establish its cap category by

filing a board-of-directors' resolution (cap resolution) with its Reserve Bank, or it can be assigned a cap category by its Reserve Bank. Generally, only those institutions that regularly incur daylight overdrafts of more than \$10 million or 20 percent of their risk-based capital on a single-day or two-week average basis are required to file a cap resolution. Institutions that do not file cap resolutions are assigned to either the exempt-from-filing or zero cap category. An institution that has not filed a resolution may not be aware of its assigned cap category and may contact its Reserve Bank to obtain this information.

Zero Cap

An institution in the zero cap category has a net debit cap of zero; thus, it may not incur daylight overdrafts in its Federal Reserve account.³ Some institutions have established management policies that prohibit daylight overdrafts. These institutions may adopt a voluntary zero cap, but they are not required by Federal Reserve policy to do so. An institution that adopts a zero cap may do so by sending a letter to its Reserve Bank. The cap will remain in effect until a cap resolution for a different cap category is filed by the institution, or until the institution becomes eligible for the exempt-from-filing status and requests that the Reserve Bank assign it to the exempt category.

^{3.} In some cases, an institution may be permitted to incur overdrafts provided they are fully collateralized, as discussed in the subsection "Overdrafts Caused by Book-Entry Securities Transfers."

In addition, an institution may be assigned a zero cap by its Reserve Bank. Institutions that may pose special risks to the Reserve Bank, such as those without access to the discount window, those incurring daylight overdrafts in violation of the Federal Reserve's PSR policy, or those in a financially weakened condition, are generally assigned a zero cap. Newly chartered institutions may also be assigned a zero cap. An institution that has been assigned a zero cap as a result of recurring daylight overdrafts in excess of its cap may generally file a resolution for a higher cap if the institution is considered to be in healthy financial condition. An institution with a zero cap should confirm its eligibility for a positive cap with the Reserve Bank before proceeding to obtain the approval of its board of directors for a de minimis cap or before beginning a self-assessment. The procedures for conducting a self-assessment are discussed later in this section.

Exempt-from-Filing

The exempt-from-filing category permits depository institutions to incur daylight overdrafts up to a net debit cap of \$10 million or 20 percent of their total risk-based capital, whichever amount is less. A Reserve Bank will assign an institution that is eligible for exempt status to this category without requiring any additional documentation. As a result, the exempt-from-filing cap category substantially reduces the administrative burden associated with obtaining a net debit cap. The majority of depository institutions that hold Federal Reserve accounts are granted exempt status

The exempt status is granted at the discretion of the Reserve Bank. To be eligible for the exempt-from-filing category, an institution must be in healthy financial condition, and it should use only minimal amounts of intraday Federal Reserve credit. Specifically, an institution's daylight overdraft history should show only infrequent overdrafts of more than \$10 million or 20 percent of its total risk-based capital, whichever amount is less. A depository institution with a new Federal Reserve account may be eligible for exempt status if it is considered to be in healthy financial condition. Furthermore, if an institution assigned to the exempt-from-filing cap category later determines that it requires more daylight overdraft capacity, it may file a cap resolution, described below, to increase its

net debit cap. Institutions in the exempt-fromfiling cap category are not required to renew their caps annually.

De Minimis Cap

Each financially healthy depository institution that regularly incurs daylight overdrafts in excess of the exempt-from-filing limitations must file a resolution with its Reserve Bank for a cap category that accommodates its normal use of intraday credit. The de minimis cap category allows institutions to incur peak daily and two-week average daylight overdrafts of up to a cap of 40 percent of their total risk-based capital. This category was designed to reduce the burden of performing a self-assessment for those institutions incurring relatively moderate levels of daylight overdrafts.

To establish the de minimis cap, an institution's board of directors must submit a cap resolution to the Reserve Bank. This resolution must approve the institution's use of intraday Federal Reserve credit in an amount up to 40 percent of its capital.

Self-Assessment Caps

Depository institutions that use intraday Federal Reserve credit in amounts that exceed 40 percent of their risk-based capital on a single day or on average over a two-week period must establish their daylight overdraft caps through the self-assessment process. This process is required to establish a cap in the average, above-average, or high categories.

In performing a self-assessment, an institution must evaluate the following four factors:

- · creditworthiness
- · intraday funds management and controls
- · customer credit policies and controls
- operating controls and contingency procedures

The institution must assign a rating based on its assessment of each of the above factors and then combine the ratings to determine its appropriate net debit cap category. An examiner's role in reviewing an institution's assessment is an important part of determining an institution's compliance with the policy. An examiner is responsible for ensuring that the institution's

underlying analysis and methodology were reasonable, and that the resultant self-assessment was generally consistent with examination findings. The following discussion provides a simplified explanation of the self-assessment factors. A more detailed explanation is contained in the manual *Guide to the Federal Reserve's Payments System Risk Policy*.

Creditworthiness. Of the four self-assessment factors, creditworthiness is the most influential in determining an overall net debit cap for a given institution. The creditworthiness factor is principally determined by a combination of the institution's capital adequacy and most recent supervisory rating. In the self-assessment, an institution's creditworthiness is assigned one of the following ratings: excellent, very good, adequate, or below standard. An excellent or a very good rating indicates that an institution demonstrates a sustained level of financial performance above its peer-group norm. As a general matter, fundamentally sound depository institutions that experience only modest weaknesses receive a rating of very good.

Most institutions will use the creditworthiness matrix to determine this component's rating. If an institution's creditworthiness rating is adequate or better, it then proceeds to rate the other three factors in the self-assessment process. The institution's assessment of the other three factors determines whether its composite rating will be lower than or equal to that determined by the creditworthiness factor. If the overall creditworthiness is either adequate or below standard, then the institution does not qualify for a positive daylight overdraft cap. In certain limited circumstances, an institution may conduct a full analysis of this component. The matrix and information regarding the full analysis are available in the Guide to the Federal Reserve's Payments System Risk Policy.

Intraday Funds Management and Control. The purpose of analyzing intraday funds management and control is to assess a depository institution's ability to fund its daily settlement obligations across all payments systems in which it participates. The analysis requires a review of funds management, credit, operations personnel, and payment activity over a period of time.

To obtain an accurate understanding of funds movements, an institution must have a good understanding of its daily use of intraday credit as well as of its use of intraday credit on average over two-week periods. The analysis covers a sufficient period of time so that an institution can determine its peak demand for intraday credit and establish its average use of such credit. The more volatile an institution's payments activity, the longer the interval that is selected for analysis. The analysis incorporates all operational areas with access to payments systems. In addition to large-dollar funds and book-entry securities-transfer activity, the review should address check clearing, ACH, currency operations, and other payment activity that results in relatively large-value settlement obligations. Thus, the analysis should not be limited to on-line payment systems, nor should it be limited to payment systems to which the institution has on-line access. Additionally, institutions with direct access to Fedwire or other payments systems in more than one Federal Reserve District must combine all of these access points into a single integrated analysis.

In performing the analysis, the institution considers both liquidity demands and the potential credit risks associated with participation in each payments system. The institution's capacity to settle its obligations in both routine and nonroutine circumstances must be carefully assessed. Thus, a complete assessment of an institution's ability to control its intraday obligations extends, in many cases, beyond its ability to control its use of Federal Reserve intraday credit within the constraints of its net debit cap. Rather, it extends to the institution's ability to control its position across all payments systems to a level that permits it to fund its obligations regularly. This type of assurance requires an institution to fully understand the nature of its obligations and to establish systems that permit it to monitor daily activity and to respond to unusual circumstances.

Customer Credit Policies and Controls. The assessment of an institution's customer credit policies and controls requires two distinct analyses:

- an analysis of the institution's policies and procedures for assessing the creditworthiness of its customers, counterparties, and correspondents
- an analysis of the institution's ability to monitor the positions of individual customers and to control the amount of intraday and interday credit extended to each customer

The analyses require the involvement of both credit and operations personnel and focus on the creditworthiness of all customers, including corporate and other depository institutions, that are active users of payment services. In addition, the creditworthiness of correspondents and all counterparties on privately operated clearing and settlement systems must be assessed.

For institutions that have arranged with a third-party service provider (discussed in the subsection "Third-Party Access Arrangements") to process payments, certain operational controls may be established in either the funds and book-entry securities-transfer operation of the service provider or in the depository institution's own operation, depending on the nature of the arrangement. In any case, the standards for customer credit control and monitoring are to be applied uniformly and extended to the service provider's operation as appropriate.

Operating Controls and Contingency Procedures. The purpose of the analysis of operating controls and contingency procedures is to assess the integrity and the reliability of a depository institution's payment operations to ensure that they are not a source of operating risk. The integrity of operations is of particular concern because operational errors and fraud can increase the cost of payment services and can undermine the confidence of the public in the payments mechanism. Similar results can occur if payment systems are unreliable and parties making and receiving payments do not have confidence that timely payments will be made.

Overall Assessment Rating. Once the four selfassessment components are analyzed and an overall rating is determined, the results must be reviewed and approved by the institution's board of directors. The directors' approval must be communicated to the Reserve Bank by submission of a board-of-directors' resolution. The Reserve Bank then reviews the cap resolution for appropriateness, in conjunction with the institution's primary regulator. If the Reserve Bank determines that the cap resolution is not appropriate, the institution is informed that it must reevaluate its self-assessment and submit another resolution. A resolution to establish a different cap category may be submitted by the institution, or it may be required by the Reserve Bank before the annual renewal date if circumstances warrant such a change.

Cap Resolutions

A board-of-directors' resolution is required to establish a cap in the de minimis, average, above-average, or high cap categories. These resolutions must follow a prescribed format. Specifically, resolutions must include the following: (1) the official name of the institution, (2) the city and state in which the institution is located, (3) the institution's routing number, (4) the date the board acted on the resolution, (5) the cap category adopted, (6) the appropriate official signature, and (7) the corporate seal. For a board resolution approving the results of a self-assessment, the resolution must identify the ratings assigned to each of the four factors of the assessment as well as the overall rating used to determine the actual net debit cap. In addition, significant liquidity or holding company factors may be addressed in the resolution; the institution must indicate if it did not use the creditworthiness-matrix approach in determining its creditworthiness rating.

Supporting documentation used in determining an appropriate cap category must be maintained at the institution. Examiners must review supporting information and material used by the institution's directors in fulfilling their responsibilities under the PSR policy. At a minimum, the following items must be maintained in the institution's cap resolution file:

- an executed copy of the resolution adopting the net debit cap
- copies of management's self-assessment of creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures
- minutes and other documentation that serve as a formal record of any discussions of the self-assessment by the directors
- status reports made available to the board of directors regarding the depository institution's compliance with resolutions adopted by the directors as well as with the PSR policy
- other materials that provide insight into the directors' involvement in carrying out their responsibilities under the PSR policy, including special studies or presentations made to the directors

De minimis and self-assessment cap resolutions are valid for one year after the date of the resolution. An institution with a de minimis cap must renew its cap resolution annually by submitting a new resolution. An institution with a self-assessment cap must perform a new self-assessment annually and submit an updated cap resolution. Procedures for submitting this resolution are the same as those for establishing a new cap; however, an institution may submit a cap resolution for a different cap category than its existing category if appropriate. Each resolution to renew a cap is reviewed for appropriateness by the Reserve Bank, in conjunction with the institution's primary supervisor.

Because the self-assessment process may, in some cases, require considerable time to complete and approve, institutions should be aware of the expiration date of their cap resolutions well in advance. If a new cap resolution is not received by the expiration date, an institution may be assigned a zero or exempt cap, which would generally preclude or reduce any use of daylight credit in the institution's Federal Reserve account.

Consequences of Cap Violations

A daylight overdraft cap violation, that is, an overdraft in excess of the single-day or two-week cap, may result in a series of actions by the Reserve Bank aimed at deterring future cap violations. The actions taken depend on the size and frequency of the overdrafts and on the financial condition of the institution. Initial actions taken by the Reserve Bank may include an assessment of the causes of the overdraft and a review of account management practices with the institution. These Reserve Bank actions are generally documented through counseling calls and letters. An institution may be required to submit documentation specifying actions it will take to address the overdraft problems.

If cap violations continue to occur, an institution may be required to increase clearing balances or pledge collateral (only in cases when the overdraft is caused by the transfer of book-entry securities) to cover its overdrafts. For a healthy institution in the exempt-fromfiling, voluntary-zero, or de minimis cap categories, the Reserve Banks may recommend that the institution perform a self-assessment and file a cap resolution to obtain a higher net debit cap. Alternatively, Reserve Banks may assign the institution a zero cap. In this situation, an

institution could also face account-activity restrictions, such as rejection of Fedwire funds transfers in excess of the account balance or account-prefunding requirements for non-Fedwire activities, such as check, ACH, and currency transactions. If the overdrafts in excess of the cap are caused by the posting of non-Fedwire transactions, the Reserve Bank may permit the overdrafts pursuant to certain account restrictions. Reserve Banks will also keep institutions' primary regulators apprised of any recurring overdraft problems.

Confidentiality of Caps

The Federal Reserve considers institutions' daylight overdraft caps and cap categories to be confidential information and will only share this information with an institution's primary supervisor. Institutions are also expected to treat cap information as confidential. Cap information should not be shared with outside parties or mentioned in any public documents.

ROLE OF DIRECTORS

The directors of a depository institution establish and implement policies to ensure that management follows safe and sound operating practices, complies with applicable banking laws, and prudently manages financial risks. Given these responsibilities, the directors play a vital role in the Federal Reserve's efforts to reduce risks within the payments system.

As part of the PSR policy, the Federal Reserve requires that directors, at a minimum, undertake the following responsibilities:

- understand the depository institution's practices and controls regarding risks assumed when processing large-dollar transactions for both its own account and the accounts of its customers or respondents
- establish prudent limits on the net debit positions that the institution incurs in its Federal Reserve account and on privately operated clearing and settlement systems
- periodically review the frequency and dollar levels of daylight overdrafts to ensure that the institution operates within the guidelines established by its board of directors (Directors should be aware that, under the Federal

Reserve's PSR policy, repeated violations of the institution's daylight overdraft net debit cap could lead to reductions in the cap, as well as the imposition of restrictions on its Federal Reserve account activity that could affect the institution's operations.)

The directors may appoint a committee of directors to focus on the institution's participation in payment systems and its use of daylight credit. Furthermore, a higher level board of the same corporate family, for example, the parent company of a bank holding company, may conduct a self-assessment review, if necessary, and approve a cap resolution. An institution's board of directors should be aware that delegating the review process to a committee or higher level board does not absolve them from the responsibilities outlined in the Federal Reserve's PSR policy. The directors cannot delegate this responsibility to an outside consultant or third-party service provider.

The Federal Reserve recognizes that directors of foreign banks do not necessarily serve in the same capacity as directors of banks in the United States. Therefore, individuals who are responsible for formulating policy at the foreign bank's head office may substitute for directors in performing the responsibilities specified in the PSR policy.

DAYLIGHT OVERDRAFT MONITORING AND MANAGEMENT

Daylight Overdraft Measurement

To determine whether a daylight overdraft has occurred in a depository institution's account, the Federal Reserve uses a set of transactionposting rules, which define explicitly the time of day that debits and credits from various transactions are posted to the account. Such debits and credits result from Fedwire funds transfers, Fedwire book-entry securities transfers, and all non-Fedwire transactions processed by a Reserve Bank. In general, all Fedwire funds and bookentry securities transfers are posted to an institution's account as they occur throughout the day. For non-Fedwire transactions, posting rules in effect since October 14, 1993, govern the timing of account debits and credits. These posting rules help institutions control their use

of intraday credit because they can monitor the time that each transaction is credited or debited to their account. Note that these posting times affect the calculation of the account balance for daylight overdraft monitoring and pricing purposes but do not affect the finality or revocability of the entry to the account. An important feature of the posting rules is a choice of posting times for check credits.

To monitor an institution's overdraft activity and its compliance with the PSR policy and to calculate daylight overdraft charges, the Federal Reserve has developed the Daylight Overdraft Reporting and Pricing System (DORPS). DORPS captures all debits and credits resulting from an institution's payment activity and calculates end-of-minute account balances using the daylight overdraft posting rules.

Monitoring Compliance with the PSR Policy

Reserve Banks generally monitor institutions' compliance with the PSR policy over each two-week reserve-maintenance period. A cap breach occurs when an institution's account balance for a particular day shows one or more negative end-of-minute account balances in excess of its single-day net debit cap. In addition, a cap breach would occur if an institution's average peak daily overdraft over a reserve-maintenance period was greater than its two-week average cap.⁴

Institutions with more than one Federal Reserve account are monitored on a consolidated basis, that is, a single account balance is derived by adding together the end-of-minute balances of each account. The accounts of affiliated institutions are monitored separately if they are separate legal entities. In addition, for institutions with accounts in more than one Federal Reserve District, an administrative Reserve Bank (ARB) is designated. The ARB coordinates the Federal Reserve's daylight overdraft monitoring activities for the consolidated accounts or institutions, such as the branches and agencies of a foreign bank. Typically, the ARB is the Reserve Bank in the Federal Reserve

^{4.} The average peak daily overdraft is calculated by adding together the largest overdraft, if any, incurred each day during a reserve-maintenance period and dividing that sum by the number of business days in the period.

District where the consolidated entity has its leading presence.

Institutions in the exempt-from-filing cap category are normally allowed two cap breaches in two consecutive two-week reservemaintenance periods without violating the PSR policy. For institutions in the de minimis or self-assessment cap categories, each cap breach resulting from funds-transfer activity is considered a policy violation, but infrequent overdrafts in excess of cap that are related to Fedwire book-entry securities-transfer activity are permitted, within the limits described below. Overdrafts in excess of cap that are due to the posting of an institution's non-Fedwire transactions (check, ACH, etc.) may be permitted pursuant to certain account restrictions that may be imposed by the Reserve Bank. In addition, a Reserve Bank may waive a cap violation if it determines that the overdraft resulted from circumstances beyond the institution's control, such as an operational failure on the part of a Reserve Bank.

Overdrafts Caused by Book-Entry Securities Transfers

Book-entry securities transactions over Fedwire are initiated by the institution sending the securities. Therefore, the receiving institution may not be able to control the time at which securities are delivered to its securities account and its funds account is correspondingly debited. As a result, daylight overdrafts caused by book-entry securities transfers are monitored separately from Fedwire funds-transfer overdrafts. For each institution, a separate end-of-minute account balance using debits and credits resulting only from book-entry securities-transfer activity is reported. This allows Reserve Banks to determine if a particular daylight overdraft was caused by book-entry securities activity.

The Federal Reserve allows institutions to increase their effective daylight overdraft capacity by pledging collateral to cover all or a portion of their book-entry securities-related overdrafts. These secured book-entry overdrafts are excluded from the calculation of overdrafts subject to the net debit cap, thereby increasing the amount of capacity available for fundstransfer and other activity. Regardless of collateral pledged, however, institutions generally may not increase their capacity for overdrafts

that are not caused by book-entry securitiestransfer activity above their net debit cap.

Furthermore, if an institution incurs bookentry overdrafts that are considered "frequent and material," the institution will be required to collateralize fully all of its book-entry overdrafts. For an institution's book-entry overdrafts to be considered frequent, such overdrafts must occur on more than three days in two consecutive reserve-maintenance periods. To be considered material, an overdraft must be more than 10 percent above the institution's net debit cap, and the book-entry-related portion of the overdraft must be more than 10 percent of the cap. Once an institution incurs frequent and material book-entry overdrafts, it will be required to pledge collateral to cover all book-entry overdrafts for six reserve-maintenance periods after its last material book-entry overdraft occurred.

Even if an institution voluntarily pledges collateral for book-entry overdraft purposes, these collateralized book-entry overdrafts are not excluded from the calculation of frequency and materiality. An institution that voluntarily pledges collateral for book-entry overdraft purposes may be required by its Reserve Bank to pledge collateral to cover fully its peak bookentry overdraft if the overdrafts in excess of its cap become frequent and material.

Institutions that are required to pledge collateral to cover all book-entry overdrafts or that voluntarily collateralize book-entry overdraft activity may pledge excess discount-window collateral (collateral pledged to the Reserve Bank for overnight borrowing purposes that is not already securing a loan), some other pool of stable collateral, or both. In-transit book-entry securities, that is, the incoming securities that cause the daylight overdraft, may be used as collateral subject to an agreement between the depository institution and its Reserve Bank. An institution that chooses to use in-transit securities as collateral must agree to provide adequate records of the pledge to the Reserve Bank and to allow the Reserve Bank to audit these collateral records periodically.

Daylight Overdraft Reporting and Pricing System

Daylight Overdraft Reporting and Pricing System (DORPS) is a Federal Reserve computer system used by Reserve Banks to determine if

an institution is in compliance with the PSR policy. It enables the Reserve Bank to identify all institutions with daylight overdrafts in excess of net debit caps or with uncollateralized bookentry overdrafts. DORPS is also used to calculate and assess charges for daylight overdrafts. In addition, DORPS maintains information on institutions' current reported capital to calculate daylight overdraft caps. These capital data normally originate in institutions' regulatory reports, such as the Reports of Condition and Income for commercial banks (call reports). DORPS also stores historical data on institutions' account balances, overdrafts, and overdraft charges.

DORPS calculates the Federal Reserve account balances of each institution minute-by-minute. For an institution maintaining more than one account at Reserve Banks, the multiple accounts are consolidated for purposes of calculating the institution's balance. Debits or credits to an institution's account resulting from transfers of funds and securities over Fedwire, and non-Fedwire transactions processed by Reserve Banks, cause fluctuations in its account balance throughout the day. Although DORPS records positive as well as negative total end-of-minute balances in each institution's account, positive end-of-minute balances do not offset negative balances at other times during the day for purposes of determining compliance with net debit caps or for calculating daylight overdraft

Account Balance Monitoring System

The Account Balance Monitoring System (ABMS) is a tool used by Reserve Banks to monitor in real time the payment activity of institutions that potentially expose the Federal Reserve and other payment system participants to risk of loss. To reduce the risks that institutions in deteriorating financial condition or institutions with a history of excessive overdraft activity may pose to the Federal Reserve and the payment system, Reserve Banks may apply real-time monitoring to an institution's account. Real-time monitoring, which relies on the capability of ABMS to intercept or reject funds transfers, may be used to prevent an institution from transferring funds from its account if there are insufficient funds to cover the payment or if the transfer would increase the institution's overdraft above its net debit cap.

SPECIAL SITUATIONS

Branches and Agencies of Foreign Banks

U.S. branches and agencies of foreign banks are typically treated the same as domestic institutions under the Federal Reserve's PSR policy. However, several unique considerations affect the way in which the policy is applied to U.S. branches and agencies of foreign banks.

In general, net debit caps for foreign banks are calculated in the same manner as for domestic banks, that is, by applying cap multiples for one of the six cap categories to a capital measure. However, the determination of an appropriate capital measure, known as the U.S. capital equivalency, is substantially different for foreign banks and depends on whether the bank is based in a country that has signed or adopted the standards of the Basle Capital Accord. In addition, special provisions regarding collateralization of overdrafts, allocation of caps, and capitalreporting requirements also apply to foreign banks. For more information refer to the Guide to the Federal Reserve's Payments System Risk Policy.

Nonbank Banks and Industrial Banks

The Competitive Equality Banking Act of 1987 (CEBA), as implemented in section 225.52 of Federal Reserve Regulation Y, prohibits a nonbank bank or an industrial bank grandfathered under the act from permitting or incurring any overdrafts on behalf of an affiliate, either on its own books or in its account at a Federal Reserve Bank. For this purpose, an affiliate is any company that controls the nonbank bank or industrial bank, is controlled by it, or is under common control with it. A nonbank bank or industrial bank loses its grandfathered status under CEBA if it permits or incurs overdrafts prohibited by CEBA. In addition, nonbank banks and industrial banks must comply with the PSR policy regarding net debit caps in the same manner as other depository institutions; these institutions are also subject to daylight overdraft fees, calculated using the same methodology as that applied to other institutions.

The prohibition does not extend to overdrafts that are the result of inadvertent computer or accounting errors beyond the control of both the nonbank bank or industrial bank and its affiliate. In addition, nonbank banks are permitted to incur overdrafts on behalf of affiliates that are primary dealers in U.S. government securities, provided such overdrafts are fully collateralized. The Federal Reserve has developed special monitoring procedures to ensure that nonbank banks and industrial banks comply with CEBA and Federal Reserve Regulation Y. For more information refer to the *Guide to the Federal Reserve's Payments System Risk Policy*.

Institutions Subject to Daylight Overdraft Penalty Fees

Under the PSR policy, institutions that have Federal Reserve accounts but are not eligible to have access to the discount window are not eligible for a positive daylight overdraft cap. These institutions are strongly discouraged from incurring any daylight overdrafts. If such an institution were to incur an overdraft, however, the Reserve Bank would generally require it to pledge collateral sufficient to cover the peak amount of the overdraft for an appropriate period.

In addition to the pledge of collateral, the institutions enumerated below are subject to a penalty fee on any daylight overdrafts incurred in their Federal Reserve accounts. The penalty fee is intended to provide a strong incentive for these institutions to avoid incurring any daylight overdrafts in their Federal Reserve accounts. The penalty fee is assessed at a rate equal to the regular daylight overdraft fee plus 100 basis points (annualized, 24-hour rate). The penalty fee is calculated and assessed in the same manner as the daylight overdraft fee charged to other institutions.

Edge Act and Agreement Corporations

Edge Act and agreement corporations⁵ do not have regular access to the discount window and should refrain from incurring daylight over-

drafts in their reserve or clearing accounts. If any daylight overdrafts occur, the Edge Act or agreement corporation will be required to pledge collateral to cover them. Like foreign banks, Edge Act and agreement corporations that have branches in more than one Federal Reserve District are monitored on a consolidated basis.

Bankers' Banks

Bankers' banks, 6 including corporate credit unions, are exempt from reserve requirements and do not have regular access to the discount window. Bankers' banks may voluntarily waive their exemption from reserve requirements, thus gaining access to the discount window. These bankers' banks would then be free to establish caps and would be subject to the PSR policies in the same manner as depository institutions. Bankers' banks that have not waived their exemption from reserve requirements should refrain from incurring overdrafts and must pledge collateral to cover any daylight overdrafts that they incur.

Limited-Purpose Trust Companies

The Board of Governors is permitted to grant Federal Reserve membership to limited-purpose trust companies 7 subject to conditions the Board may prescribe. Limited-purpose trust companies that maintain Federal Reserve accounts should refrain from incurring overdrafts and must pledge collateral to cover any daylight overdrafts that they incur.

^{5.} These institutions are organized under section 25A of the Federal Reserve Act (12 USC 611–631) or have an agreement or undertaking with the Board of Governors under section 25 of the Federal Reserve Act (12 USC 601–604a).

^{6.} For the purposes of this policy, a bankers' bank is a financial institution that is not required to maintain reserves under the Federal Reserve's Regulation D (12 CFR 204) because it is organized solely to do business with other financial institutions, is owned primarily by the financial institutions with which it does business, and does not do business with the general public and is not a depository institution as defined in the Federal Reserve's Regulation A (12 CFR 201.2(a)).

^{7.} For the purposes of this policy, a limited-purpose trust company is a trust company that, because of limitations on its activities, does not meet the definition of "depository institution" in section 19(b)(1)(A) of the Federal Reserve Act (12 USC 461(b)(1)(A)).

Interaffiliate Transfer Arrangements

The PSR policy permits the transfer of funds over Fedwire among affiliated institutions for the purpose of simulating consolidation of net debit caps within holding companies. Affiliated institutions send funds transfers in amounts up to their net debit caps to a lead institution at the opening of business each day, and the lead affiliate returns the funds at the end of the day. These transfers may not exceed the sending institution's net debit cap.

Under the policy, the main requirements for entering into interaffiliate transfer arrangements are the following:

- Each year, the sending institution's board of directors must specifically approve the extension of credit to specified affiliates and must send a copy of the interaffiliate resolution to its Reserve Bank.
- The institution's primary supervisor determines during the regular examination process that (1) the directors' resolution has been passed in the last 12 months, (2) limits have been established on the extension of credit to each affiliate, (3) controls have been established to ensure adherence to the limits, and (4) the limits are determined to be effective.

It should be noted that parent companies of Edge Act or agreement corporation subsidiaries are permitted to fund their subsidiaries without submitting interaffiliate transfer agreements. These institutions are considered subsidiaries of the bank rather than direct subsidiaries of a holding company.

Third-Party Access Arrangements

Under certain conditions, the Federal Reserve permits arrangements whereby a sending or receiving institution (referred to as the "participant") may enter into an agreement with a third party (the "service provider") to initiate, receive, or otherwise process Fedwire funds transfers or book-entry securities transfers from the reserve or clearing account of the participant. Because all payment activity from third-party access arrangements is posted to the participant's reserve or clearing account held at the Federal Reserve, the participant remains responsible for its account, the associated reserve

maintenance, and the establishment of and compliance with its net debit cap.

Of primary importance in third-party arrangements is assurance that the participant retains ultimate control over the decision-making process. That is, it must not allow the service provider to have unlimited and unsupervised access to its Federal Reserve account. As a result, the Federal Reserve permits third-party arrangements only under carefully controlled conditions. The participant must retain operational control of the credit-granting process by either (1) individually authorizing each funds or securities transfer or (2) establishing individualcustomer transfer limits and a transfer limit for its own activity, within which the service provider can act. The transfer limit could be a combination of the account balance and established credit limits. These arrangements are called "line-of-credit arrangements." The service provider must have procedures in place and the operational ability to ensure that a funds transfer that would exceed the established transfer limit is not permitted without first obtaining the participant's approval. In book-entry securities transfer line-of-credit arrangements, the service provider needs procedures in place and the operational ability to provide the participant with timely notification of an incoming transfer that exceeds the applicable limit and must act on the participant's instructions to accept or reverse the transfer accordingly. The participant should periodically review the appropriateness of the credit limits as part of its ongoing review process.

Because the responsibility for management of the institution's reserve or clearing account remains with the participant, each participant must also monitor its own Federal Reserve account position, either by having an on-line terminal connection with its service provider or through a prompt review of accounting information from its Reserve Bank. The participant's board of directors must approve all transfer agreements outlining the role and responsibilities of a service provider that is not affiliated with the participant through at least 80 percent common ownership. In line-of-credit arrangements, the participant's board of directors must approve the intraday overdraft limit for the activity to be processed by the third-party service provider and approve all credit limits for any interaffiliate funds transfers. In cases where a U.S. branch of a foreign bank wishes to be a participant in a third-party service arrangement,

the role and responsibilities of the service provider may be reviewed by senior management at the foreign bank's head office if senior management exercises authority over the foreign bank equivalent to the authority exercised by a board of directors over a U.S. depository institution.

The Federal Reserve Board issued the Fedwire third-party access arrangements involving a service provider that is located outside the United States, which were effective February 1, 1996. In general, foreign-service-provider arrangements would be subject not only to the conditions applicable to domestic-service-provider arrangements, but also to several additional conditions related to information and examination access.

For the purposes of conducting a selfassessment, the participant should consider its degree of control and reliance on the service provider for operational controls and monitoring positions. Regardless of the servicing arrangement, the timeliness and quality of information available to the management of the participant should be reflected in its self-assessment. Customer-monitoring standards should be applied to the operation where customer information is controlled and credit limits enforced. If a service provider is authorized to process payments within credit limits established by the participant, the self-assessment standards for operational controls should generally be applied to the operation of the service provider. In cases in which the service provider operates under credit limits but relies on customer accounting information maintained by the participant, customermonitoring standards addressing the quality of the information must be applied at the participant, while controls limiting payments would be enforced at the service provider.

The Board of Governors expects all participants to ensure that their Fedwire operations could be resumed in a reasonable period of time in the event of an operating outage, consistent with the requirement to maintain adequate contingency back-up capabilities as set forth in the "Interagency Policy Statement on Contingency Planning for Financial Institutions," (FFIEC SP-5, July 1989). For nonaffiliated third-party servicers, the participant must be able to continue Fedwire operations either internally or with an alternate provider if the original service-provider arrangement is terminated. A participant is not relieved of this responsibility because it contracts with a service provider.

The participant must certify that the arrange-

ment is consistent with corporate separateness and does not violate branching restrictions. To satisfactorily address safety-and-soundness concerns, the participant should have an adequate audit program to review the arrangement at least annually to confirm that these requirements are being met. In addition, in the case of an arrangement involving a foreign service provider, both the participant and the foreign service provider must have in place an adequate audit program that addresses Fedwire operations. Audit reports in English must be made available to the Federal Reserve and the participant's primary supervisor(s) in the United States. Further, the participant's primary supervisors must approve in writing the third-party-servicer arrangement. The participant should certify that the specifics of the arrangement will allow it to comply with all applicable state and federal laws and regulations, including retaining records and making them accessible in accordance with the regulations adopted under the Bank Secrecy Act.

The service provider must be subject to examination by the appropriate federal depository institution regulatory agencies. In the case of a service provider located outside the United States, the service provider must be subject to the supervision of a home-country bank supervisor. The participant and the service provider must agree to make all policies, procedures, and other documentation relating to Fedwire operations, including those related to internal controls and data-security requirements, available to the Federal Reserve and the participant's primary supervisor(s) in English. Further, the participant and the service providers must execute an agreement with the relevant Reserve Banks to incorporate these conditions. If an arrangement is proposed in which the participant is not affiliated through at least 80 percent common ownership with the service provider and in which the participant is owned by one of the 50 largest bank holding companies, or in which the service provider is located outside the United States, the division directors of Reserve Bank Operations and Payment Systems and of Banking Supervision and Regulation must concur with the arrangement.

ELECTRONIC FUNDS TRANSFER MANAGEMENT

Economic and financial considerations have led

to a growing recognition on the part of financial institutions and their customers of the need to manage cash resources more efficiently. The PSR policy calls on private networks and depository institutions to reduce their own credit and operational risks. It also depends, in part, on the role of the Federal Reserve and other financial-institution regulators in examining, monitoring, and counseling institutions. To ensure that prudent banking practices are being followed by banking institutions in their funds-transfer activities, examinations should focus equally on the evaluation of both credit risks and operational risks.

The bank should establish guidelines for types of allowable transfers. Procedures should be in effect to prevent transfers drawn against uncollected funds. Thus, banks should not transfer funds against simple ledger balances unless preauthorized credit lines have been established for that account.

Errors and omissions or fraudulent alteration of the amount of a transfer or the account number to which funds are to be deposited could result in losses to the bank. Losses may include total loss of the transferred funds, loss of availability of funds, interest charges, and administrative expenses associated with the recovery of the funds or correction of the problem.

Management is responsible for assessing the inherent risks in the EFT system, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of safeguards. Regulatory agencies will ensure that each financial institution has evaluated its own risks realistically and has adequate accounting records and internal controls to keep exposures within reasonable, established limits.

The risks associated with any computerized EFT system can be reduced if management implements the controls that are available on the system. For example, the authority to enter, verify, and send transfers can be segregated. Also, the dollar amount of the transactions can be limited.

Effective risk management requires that—

- reasonable credit limits be established and payments in excess of such limits involving significant credit risk be properly approved by appropriate lending authorities,
- banks have adequate recordkeeping to determine the extent of any intraday overdrafts and

- potential overnight overdrafts before releasing payments, and
- institutions responsible for setting the positions of others should properly monitor respondents' accounts and assign responsibility for this function to an appropriate supervisory level of management.

AUTHENTICATION OR VERIFICATION METHODS

The same due care that financial institutions use when executing EFT transactions must also be used when accepting EFT requests from customers. Management must implement security procedures for ensuring that the transfer requests are authentic. As stated in Uniform Commercial Code section 4A-201, security procedures may require the use of algorithms or other codes, identifying words, or numbers; encryption; callback procedures; or similar security devices. Authorized and verified payment orders are detailed in UCC section 4A-202.

Signature Verification

One method to verify the authenticity of a customer's EFT request is to verify the customer's signature. Unfortunately, this procedure cannot be performed when the customer requests the transaction by telephone. Some financial institutions have implemented policies whereby the customer completes and signs a transfer request, and then faxes the request to the bank. However, this is not a safe EFT procedure because, although the bank can verify the signature on the faxed request, it cannot be certain that the transfer request is legitimate. Any document that is transmitted electronically can be altered (for example, by changing the amount or account number); the alteration can occur before the document is digitalized (that is, before being fed into the fax machine) or after. In most instances, these alterations cannot be detected by the receiving entity. If there is any question about a document's authenticity, the transaction should be reconfirmed through other sources.

Personal Identification Numbers

One way for financial institutions to authenticate

transfers initiated over the telephone is through the use of personal identification numbers (PIN) issued to each customer. When a customer requests a transfer, the customer's identity is verified by comparing the PIN that is supplied with the customer PIN request form that is on file. At a minimum, the following safeguards for these types of transfers should be implemented:

- All customers should be requested to sign an agreement whereby the bank is held harmless in the event of an unauthorized transfer if the bank follows routine authentication procedures. The customer is responsible for informing the bank about changes in who is authorized to execute EFTs. These procedures should minimize the risk to the bank in the event someone is able to execute a fraudulent transaction. These procedures are described in detail in UCC section 4A-202, "Authorized and Verified Payment Orders."
- All transactions over a specific dollar amount should be reverified by a callback routine. The bank should require that the person being called for reverification is someone other than the person who initially requested the transaction.
- Whenever new PINs are issued, they should be mailed in sealed, confidential envelopes (preferably computer-generated) by someone who does not have the ability to execute wire transfers.
- The number of bank employees with access to the PINs should be very limited.

Tape Recording

Tape recording EFT requests made over the telephone is another internal control practice. Likewise, when possible, verifying and recording the incoming telephone number (that is, the caller-I.D. system) is a good practice. The laws addressing telephone recording vary by state. Some states require that the caller be informed that the conversation is being recorded; other states do not have this requirement. Regardless of the state's law, the bank should inform callers that, for their protection, conversations are being recorded. Moreover, banks should have in place a policy for archiving the taped telephone records and should retain them for a specified period of time or at least until the statements from the Federal Reserve or correspondent banks have been received and reconciled.

Statements of Activity

Some larger banks have implemented a procedure whereby customers are electronically sent a summary statement at the end of each day that lists the transfers executed and received on their behalf. The statement can be sent through a fax machine, a personal computer, or a remote printer. This procedure can serve to quickly identify any transfers that were not authorized by the customer.

Test Keys

EFT requests can also be authenticated by using "test keys." A test key is a calculated number that is derived from a series of codes that are contained in a "test-key book." The codes in a test-key book represent such variables as the current date, hour of the day, receiving institution, receiving account number, and amount of the transfer. The value derived from these variables equals the test key. The financial institution or corporate customer initiating the transfer will give its EFT information, along with the test-key value. The receiving bank will recalculate the test key and, if the two test keys equal the same amount, the EFT request is considered authenticated. Test-key code books should be properly secured to prevent unauthorized access or fraudulent use. The use of test keys has declined in recent years as more and more institutions implement personal computer-based EFT systems.

INTERNAL CONTROL

Blanket Bond

Although computer-related employee misappropriations are normally covered, financial-institution blanket bond policies generally exclude certain types of EFT activities from standard coverage. Separate coverage for EFT systems is available and should be suggested to management, particularly if a significant risk exposure exists. A bank's fidelity bond insurance could be declared null and void by the carrier if a fraudulent transfer were to occur and the loss was directly attributable to weak internal controls.

Supervisory Evaluation

Bank management is responsible for assessing the inherent risks in the EFT system it uses, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of such safeguards. Bank examiners are responsible for ensuring that financial institutions have evaluated their own risks realistically and have provided internal controls that are adequate to keep the exposures within acceptable limits. Examiners should consider the following internal control guidelines when they review policies and procedures covering funds-transfer activities:

- Job descriptions for personnel responsible for a bank's EFT activities should be well defined. They should provide for the logical flow of work and adequate segregation of duties.
- No single person in an EFT operation should be responsible for all phases of the transaction (that is, for data input, verification, and transmission/posting).
- All funds transfers should be reconciled at the end of each business day. The daily balancing process should include a reconciliation of both the number and dollar amount of messages transmitted.

- All adjustments required in the processing of a transfer request should be approved by a bank's supervisory personnel, with the reasons for the adjustment documented. Transfer requests "as of" a past or future date should require the supervisor's approval with welldefined reasons for those requests.
- Only authorized persons should have access to EFT equipment.

Considerable documentation is necessary to maintain adequate accounting records and auditing control. Many banks maintain transferrequest logs, assign sequence numbers to incoming and outgoing messages, and keep an unbroken electronic copy of all EFT messages. At the end of each business day, employees who are independent of the transfer function should compare request forms to the actual transfers to ensure that all EFT documents are accounted for.

In summary, examiners should review the funds-transfer operations to determine that recordkeeping systems are accurate and reliable, all transactions are handled promptly and efficiently, duties are separated appropriately, audit coverage is adequate, and management recognizes the risks associated with these activities.

Payments System Risk and Electronic Funds Transfer Activities Examination Objectives

Effective date November 1995

Section 4125.2

- To determine if wire transfer objectives, policies, practices, procedures, and internal controls are adequate.
- To determine if bank officers and other wire transfer personnel are operating in conformance with established guidelines.
- To determine the scope and adequacy of the audit function.
- To determine that senior management is informed of the current status of and any exposure relative to wire transfer operations.
- 5. To determine that the board of directors has reviewed and approved the institution's assessment and sender net debit cap, if applicable, in conformance with the Board's policy statement on risk reduction on largedollar payments systems.
- 6. To determine compliance with applicable laws and regulations.
- To obtain initiation of corrective action when objectives, policies, procedures or internal controls are deficient or when violations of laws or regulations have been noted.

Payments System Risk and Electronic Funds Transfer Activities Examination Procedures

Effective date December 1986

Section 4125.3

- If selected for implementation, complete or update the Wire Transfer section of the Internal Control Questionnaire.
- Based upon an evaluation of internal controls and work performed by internal/ external auditors, determine the scope of the examination.
- 3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if appropriate corrections have been made.
- Obtain or construct an organizational chart and flowchart for the wire transfer area and determine job responsibilities and flow of work through that department.
- 5. Review the bank's standard form or other written agreements with its customers, correspondent banks, and vendors and determine whether those agreements are current and clearly define the liabilities and responsibilities of all parties, including responsibilities during emergencies. Agreements with the Federal Reserve Bank should refer specifically to the operating circular(s) regarding wire transfer of funds pursuant to subpart B of Regulation J.
- Review the bank's policies with respect to third-party transactions and determine their reasonableness.
- 7. For transactions involving the Federal Reserve Bank and other due from bank accounts, confer with the examiner assigned "Due from Banks" and determine the propriety of any outstanding funds transfer items.
- 8. Determine the bank's basis for accepting customers for the CHIPS clearing activity.
 - a. If the examined institution is a settling CHIPS participant, determine the criteria for accepting a nonsettling participant as a respondent.
 - Determine that the criteria are reviewed periodically.
 - Determine whether periodic credit reviews of funds transfer customers are made by credit personnel indepen-

- dent of account and operations officers. The reviews should be adequately documented.
- b. For the settling institutions on CHIPS, determine that net debit positions of the nonsettling participants are relayed to appropriate personnel as soon as they become known and that respondents' net debit positions are covered the same day. A decision to refuse to cover a net debit settlement position of a respondent should come from senior management.
- c. Discuss with the examiners working the loan programs and decide who should analyze credit exposures arising from wire transfer activities.
- For institutions incurring daylight overdrafts, determine that the board of directors has reviewed and approved the institution's assessment and sender net debit cap in conformance with the Board's policy statement on risk reduction on large-dollar payments systems.
- Determine where suspense items or adjustment accounts are posted and who reviews suspense items for resolution.
 - Scan accounts for unusual or old items, abnormal fluctuations, or evidence of inefficient operation.
 - b. Agree accounts to departmental control totals and to the general ledger.
 - c. Review management reports on suspense items and unusual activity.
- Review the income and expense accounts related to wire transfer operations for frequency of entries caused by late or inaccurate execution of transfer requests.
- 12. By observing space and personnel allocated to the wire transfer area and location of communications terminals, determine whether existing conditions are adequate to provide security.
- 13. Determine compliance with laws and regulations pertaining to the wire transfer area by:
 - a. Reviewing previously obtained material and comparing it to Federal Reserve Regulation J, subpart B.
 - b. Analyzing compliance with the record retention requirements of 31 CFR 103.33, 103.34, and 103.36 by:

- Determining if the bank maintains a record of advices, requests or instructions given to another domestic financial institution regarding a transaction intended to result in the transfer of funds of more than \$10,000 to a person, account, or place outside the United States for a period of five years.
- Determining if the bank retains an original or copy of documents granting signature authority over wire transfers from deposit accounts for a period of five years.
- c. Reviewing funds transfers activities of Edge corporations in conjunction with Regulation K, section 211.6(b).
- 14. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:

- a. Internal control exceptions and deficiencies in, or noncompliance with, written policies, practices, and procedures.
- b. Uncorrected audit deficiencies.
- c. Violations of laws and regulations.
- d. The level of understanding by supervisory officers of definitions, terminology, operating arrangements, accounting procedures, and time limitations concerning wire transfer operations.
- The operating efficiency and physical security of the bank's wire transfer operation.
- Recommended corrective action when policies, practices, or procedures are deficient.
- 15. Update the workpapers with any information that will facilitate future examinations.

Payments System Risk and Electronic Funds Transfer Activities Internal Control Questionnaire

Effective date March 1984

Section 4125.4

Review the bank's internal controls, policies, practices and procedures regarding wire transfer activities. The bank's system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

SIGNATURE CARD CONSIDERATIONS

- 1. Does management maintain a current list of bank personnel authorized to initiate transfer requests?
- 2. Does the bank limit the number of authorized employees?
- *3. Are authorized employee signature cards kept under dual control?
- 4. Does the bank maintain a current list or card file of authorized signers for customers who use the bank's funds transfer services?
- 5. Does the bank limit the number of authorized signers for bank customers?
- 6. Are customer signature cards maintained under dual control or otherwise protected?
- Do customer signature cards limit the amount of funds that an individual is authorized to transfer?
- 8. Does the bank advise its customers to maintain their lists of authorized signers under dual control?
- 9. Do bank personnel compare the signature on an original mail request with the authorized signature on file?

TEST KEY CONSIDERATIONS

- *10. Are the files containing test key formulas maintained under dual control or otherwise protected?
 - 11. Are only authorized personnel permitted in the test key area or allowed access to computers, teletapes or terminals?
 - 12. Does the bank maintain an up-to-date test key file?

- 13. Does management maintain a list of those persons who have access to test key files?
- 14. Are all messages and transfer requests that require testing authenticated by the use of a test key?
- *15. Are test codes verified by someone other than the person receiving the initial transfer request?
 - 16. Are call-back or other authentication procedures performed on all transfers that do not have a test key or signature card on file?
 - 17. Do mail transfer requests include a test word as an authentication procedure?
 - 18. Does the bank's test key formula incorporate a sequence number resulting from an agreement between the bank and the customer?
 - 19. Does the bank have procedures in operation for the issuance and cancellation of test keys?
- *20. Is the responsibility for issuing and cancelling test keys assigned to someone who is not responsible for testing the authenticity of transfer requests?

TELEPHONE TRANSFER REQUESTS

- 21. Has the bank established guidelines for what information should be obtained from a person making a funds transfer request by telephone?
- 22. Does that information include a test word authentication code?
- 23. Does the bank use a call-back procedure that includes a test code authentication to verify telephone transfer requests?
- 24. Does the bank limit call-back to transactions over a certain dollar amount?
- 25. Does the bank maintain a current list of persons authorized to initiate telephonic funds transfers and messages?
- *26. Does the bank have procedures in effect to prohibit persons who receive telephone transfer requests from transmitting those requests?
- 27. Does the bank use devices that record all incoming and outgoing transfer requests?
- 28. Does the bank advise its customers in

- written contracts, by audible bleeping signals, or by informing the caller that telephone calls are being recorded?
- 29. Are pre-numbered or sequentially numbered (at a central location after initiation) transfer request forms used?
- 30. Are transfer requests recorded in a log or another bank record at origination?
- 31. Is the log or record of transfer requests reviewed daily by supervisory personnel?
- 32. Do the records of transfer requests contain:
 - a. A sequence number?
 - b. An amount transferred?
 - c. The person, firm or bank making request (also specific transferror)?
 - d. The date?
 - e. The test code authentication?
 - f. Paying instructions?
 - g. Authorizing signatures for certain types and dollar amount transfers?

WIRE TRANSFER REQUESTS

- 33. Does the bank have teletype or computer terminal equipment capable of receiving and transmitting messages and funds transfer information?
- *34. Are the functions of receipt, testing and transmission of funds transfer requests performed by different employees?
- 35. Are incoming and outgoing messages time stamped or sequentially numbered for control?
- 36. Do incoming and outgoing messages include a test word as a means of message authentication?
- 37. Is an unbroken copy of all messages kept throughout the business day?
- 38. Is that copy reviewed and controlled by someone not connected with operations in the wire transfer area?

ACCOUNTING, PROCESSING, AND SYSTEMS

- 39. Does the wire transfer department of the bank prepare a daily reconcilement of funds transfer activity by dollar amount and number of messages?
- 40. Is a daily reconcilement of funds transfer activities performed in another area of the bank, i.e., correspondent banks, account-

- ing, or by a person divorced from any money transfer operations?
- 41. Are all pre-numbered forms, including cancellations, accounted for in the daily reconcilement?
- 42. Is the daily reconcilement of funds transfer and message request activity reviewed by supervisory personnel?
- *43. Is the balancing of the daily activity separate from the receiving, processing and sending functions?
 - 44. Does the wire transfer department verify that work sent to other bank departments agrees with its totals?
- 45. Is someone responsible for reviewing all transfer requests to determine that they have been properly processed?
- 46. Are all rejects and/or exceptions reviewed by someone not involved in the receipt, preparation or transmittal of funds?
- 47. If the institution accepts transfer requests after the close of business or transfer requests with a future value date, are they properly controlled and processed?
- 48. Are Federal Reserve Bank statements reviewed daily to determine if there are "open" funds transfer items and the reasons for the outstanding items?
- 49. Are corrections, overrides, open items, reversals and other adjustments reviewed and approved by an officer?
- 50. Does the wire transfer department or another area of the bank have procedures in effect to prohibit transfers of funds against accounts that do not have preauthorized credit availability and have uncollected balances?
- 51. Does the bank maintain adequate records as required by the Currency and Foreign Transactions Reporting Act of 1970 (also known as the Bank Secrecy Act)?
- 52. Have managing officers adopted written procedures or flowcharting to serve as a training tool?
- 53. Does management and/or the audit department undertake a periodic review to ensure that work is being performed in accordance with established policy?
- 54. Is the audit department promptly informed when a change is made in systems or method of operation?
- 55. Are all general ledger tickets, automated transaction cards or other supporting documents initialed?

PERSONNEL

- 56. Has the bank taken steps to ensure that screening procedures are applied to personnel hired for sensitive positions in the wire transfer department?
- 57. Does the bank prohibit new employees from working in sensitive areas of the wire transfer operation?
- 58. Are temporary employees excluded from working in sensitive areas? If not, is the number of such employees limited?
- 59. Are statements of indebtedness required of employees in sensitive positions of the wire transfer function?
- 60. Are employees subject to unannounced rotation of responsibilities regardless of the size of the institution?
- 61. Are relatives of employees in the wire transfer function precluded from working in the same institution's bookkeeping or data processing departments?
- 62. Does the bank's policy require that employees take a minimum number of consecutive days as part of their annual vacation? Is this policy being enforced?
- 63. Does management reassign employees who have given notice of resignation or been given termination notices, from sensitive areas of the wire transfer function?

PHYSICAL SECURITY

- 64. Is access to the wire transfer area restricted to authorized personnel?
- 65. Are visitors to the wire transfer area identified, required to sign in and be accompanied at all times?
- 66. Is written authorization given to those employees who remain in the wire transfer area after normal working hours? Who gives such authority? Are security guards informed?
- 67. Are bank terminal operators or others in wire transfer operations denied access to computer areas or programs?
- 68. Do procedures prohibit computer personnel from gaining access to bank terminals or test key information?
- 69. Does wire transfer equipment have physical and/or software locks to prohibit access by unauthorized personnel at all times?

- 70. Are terminals and other hardware in the wire transfer area shut down after normal working hours? Regulated by automatic time-out controls or time-of-day controls?
- 71. Are passwords suppressed when entered in terminals?
- 72. Are operator passwords frequently changed? If so, how often?
- 73. Is supervisory approval required for terminal access made at other than authorized times?
- 74. Are passwords restricted to different levels of access such as data files and transactions that can be initiated?
- 75. Is terminal operator training conducted in a manner that will not jeopardize the integrity of live data or memo files?
- 76. Are employees prohibited from taking keys for sensitive equipment out of the wire transfer area?
- 77. Does the bank maintain back-up communications systems?
- 78. Are back-up systems periodically tested by bank personnel?
- 79. Does the use of back-up equipment require approval by supervisory personnel?

CONTINGENCY PLANS

- 80. Have written contingency plans been developed for partial or complete failure of the systems and/or communication lines between the bank and the New York Clearing House, Federal Reserve Bank, data centers and/or servicer companies?
- 81. Are these contingency plans reviewed regularly and tested periodically?
- 82. Has management distributed these plans to all wire transfer personnel?
- 83. Are sensitive information and equipment adequately secured before evacuation in an emergency and is further access to the affected areas denied by security personnel?

CREDIT EVALUATION AND APPROVAL

84. Have customer limits been established for Fedwire, CHIPS, and Cash Wire exposure which include consideration of intraday and overnight overdrafts?

- a. Are groups of affiliated customers included in such limits?
- b. How often are the limits reviewed and undated?
- c. Are the customer limits reviewed by senior management? How frequently?
- 85. Does the bank make payments in anticipation of the receipt of covering funds? If so, are such payments approved by officers with appropriate credit authority?
- 86. Are intraday exposures limited to amounts expected to be received the same day?
- 87. Are intraday overdraft limits established in consideration of other types of credit facilities for the same customer?
- 88. Is an intraday posting record kept for each customer showing opening collected and uncollected balances, transfers in, transfers out, and the collected balances at the time payments are released?
- 89. If payments exceed the established limits, are steps taken in a timely manner to obtain covering funds?

90. When an overnight overdraft occurs, is a determination made as to whether a fail caused the overdraft? If so, is this properly documented? Is adequate follow-up made to obtain the covering funds in a timely manner?

CONCLUSION

- 91. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- 92. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Effective date May 1998

The role of bank regulators in supervising private-banking activities is (1) to evaluate management's ability to measure and control the risks associated with such activities and (2) to determine if the proper internal control and audit infrastructures are in place to support effective compliance with relevant laws and regulations. In this regard, the supervisors may determine that certain risks have not been identified or adequately managed by the institution, a potentially unsafe and unsound banking practice.

Private-banking functions may be performed in a specific department of a commercial bank, an Edge corporation or its foreign subsidiaries, a nonbank subsidiary, or a branch or agency of a foreign banking organization or in multiple areas of the institution. They may also be the sole business of an institution. Regardless of how an institution is organized or where it is located, the results of the private-banking review should be reflected in the entity's overall supervisory assessment.¹

This section provides examiners with guidance for reviewing private-banking activities at all types and sizes of financial institutions. It is intended to supplement, not replace, existing guidance on the examination of private-banking activities and to broaden the examiner's review of general risk-management policies and practices governing private-banking activities. In addition to providing an overview of private banking, the general types of customers, and the various products and services typically provided, the Functional Review subsection describes the critical functions that constitute a private-banking operation and identifies certain safe and sound banking practices. These critical functions are Supervision and Organization, Risk Management, Fiduciary Standards, Operational Controls, Management Information Systems, Audit, and Compliance. Included in the riskmanagement portion is a description of the basic "know-your-customer" (KYC) principle that is the foundation for the safe and sound operation of a private-banking business. A self-explanatory Preparation for Examination subsection assists in defining the examination scope and provides a list of core requests to be made in the first-day letter. References also are made throughout this section to additional examination guidance in this manual and in the Federal Reserve System's Bank Secrecy Act Manual, Trust Examination Manual, EDP Examination Manual, and Trading and Capital-Markets Activities Manual.

In reviewing specific functional and productexamination procedures (found in the privatebanking activities module that is part of the framework for risk-focused supervision of large complex institutions), all aspects of the privatebanking review should be coordinated with the rest of the examination to eliminate unnecessary duplication of effort. Furthermore, this section has introduced the review of trust activities and fiduciary services, critical components of most private-banking operations, as part of the overall private-banking review. Although the product nature of these activities differs from that of other banking activities, such as lending and deposit taking, the functional components of private banking (supervision and organization, risk management, operational controls and management information systems, audit, compliance, and financial condition/business profile) should be reviewed across product lines.

OVERVIEW

Private banking offers the personal and discrete delivery of a wide variety of financial services and products to the affluent market, primarily to high net worth individuals and their corporate interests. A private-banking operation typically offers its customers an all-inclusive moneymanagement relationship, including investment portfolio management, financial-planning advice, offshore facilities, custodial services, funds transfer, lending services, overdraft privileges, hold mail, letter-of-credit financing, and bill-paying services. As the affluent market grows, both in the United States and globally, competition to serve it is becoming more intense. Consequently, new entrants in the private-banking marketplace include banks and nonbank financial institutions, and private-banking products, services, technologies, and distribution channels are still evolving. A range of private-banking products and services may be offered to customers throughout an institution's global network of

Throughout this section, the word "bank" will be used to describe all types of financial institutions, and the term "board of directors" will be interchangeable with "senior management" of branches and agencies of foreign banks.

affiliated entities—including branches, subsidiaries, and representative offices—in many different regions of the world, including offshore secrecy jurisdictions.

Typically, private-banking customers are high net worth individuals who have minimum investible assets of \$1 million. Institutions often differentiate domestic from international private banking, and they may further segregate the international function based on the geographic location of their international client base. International private-banking clients may be wealthy individuals who live in politically unstable nations and are seeking a safe haven for their capital. Therefore, obtaining detailed background information and documentation about the international client may be more difficult than it is for the domestic customer. Privatebanking accounts may, for example, be opened in the name of an individual, a commercial business, a law firm, an investment advisor, a trust, a personal investment company (PIC), or an offshore mutual fund.

Private-banking accounts are usually generated on a referral basis. Every client of a private-banking operation is assigned a salesperson or marketer, commonly known as a relationship manager (RM), as the primary point of contact with the institution. The RM is generally charged with understanding and anticipating the needs of his or her wealthy clients, and then recommending services and products for them. The number of accounts an RM handles can vary, depending on the portfolio size or net worth of the particular accounts. RMs strive to provide a high level of support, service, and investment opportunities for their clients and tend to maintain strong, long-term client relationships. Frequently, RMs take accounts with them to other private-banking institutions if they change employment. Historically, initial and ongoing due diligence of private-banking clients is not always well documented in the institution's files because of RM turnover and confidentiality concerns.

Clients may choose to delegate a great deal of authority and discretion over their financial affairs to RMs. Given the close relationship between clients and their account officers, an integral part of the examination process is assessing the adequacy of managerial oversight of the nature and volume of transactions conducted within the private-banking department or with other departments of the financial institution, as well as determining the adequacy and

integrity of the RM's procedures. Policy guidelines and management supervision should provide parameters for evaluating the appropriateness of all products, especially those involving market risk. Moreover, because of the discretion given to RMs, management should develop effective procedures to review client-account activity to protect the client from any unauthorized activity. In addition, ongoing monitoring of account activity should be conducted to detect activity that is inconsistent with the client profile (for example, frequent or sizeable unexplained transfers flowing through the account).

Finally, as clients develop a return-on-assets (ROA) outlook to enhance their returns, the use of leveraging and arbitrage is becoming more evident in the private-banking business. Examiners should be alert to the totality of the client relationship product by product, in light of increasing client awareness and use of derivatives, emerging-market products, foreign exchange, and margined accounts.

Products and Services

Personal Investment Companies, Offshore Trusts, and Token Name Accounts

Private-banking services almost always involve a high level of confidentiality regarding client-account information. Consequently, it is not unusual for private bankers to help their clients achieve their financial planning, estate planning, and confidentiality goals through offshore vehicles such as PICs, trusts, or more exotic arrangements, such as hedge-fund partnerships. While these vehicles may be used for legitimate reasons, without careful scrutiny, they may camouflage illegal activities. Private bankers should be committed to using sound judgment and enforcing prudent banking practices, especially when they are assisting clients in establishing offshore vehicles or token name accounts.

Through their global network of affiliated entities, private banks often form PICs for their clients. These "shell" companies, which are incorporated in offshore secrecy jurisdictions such as the Cayman Islands, Channel Islands, Bahamas, British Virgin Islands, and Netherlands Antilles, are formed to hold the customer's assets as well as offer confidentiality by opening accounts in the PIC's name. The "beneficial owners" of the shell corporations are typically

foreign nationals. The banking institution should know and be able to document that it knows the beneficial owners of such corporations and that it has performed the appropriate due diligence to support these efforts. Emphasis should be placed on verifying the source or origin of the customer's wealth. Similarly, offshore trusts established in these jurisdictions should identify grantors of the trusts and sources of the grantors' wealth. Anonymous relationships or relationships in which the RM does not know and document the beneficial owner should not be permitted.

Deposit Taking

A client's private-banking relationship frequently begins with a deposit account, and then expands into other products. In fact, many institutions require private-banking customers to establish a deposit account before maintaining any other accounts. Deposit accounts serve as conduits for a client's money flows. To distinguish private-banking accounts from retail accounts, institutions usually require significantly higher minimum account balances and assess higher fees. The private-banking function or institution should have account-opening procedures and documentation requirements that must be fulfilled before a depository account can be opened. (These standards are described in detail in the Functional Review subsection.)

Most private banks offer a broad spectrum of deposit products, including multicurrency deposit accounts that are used by clients who engage in foreign-exchange, securities, and derivatives transactions. The client's transaction activity, such as wire transfers, check writing, and cash deposits and withdrawals, is conducted through deposit accounts (including current accounts). It is very important that the transaction activity into and out of these deposit accounts be closely monitored for suspicious transactions that are inconsistent with the client's profile of usual transactions. Suspicious transactions could warrant the filing of a suspicious-activity report.

Investment Management

In private banking, investment management usually consists of two types of accounts: (1) discretionary accounts in which portfolio managers

make the investment decisions based on recommendations from the bank's investment research resources and (2) nondiscretionary (investment advisory) accounts in which clients make their own investment decisions when conducting trades. For nondiscretionary clients, the banks typically offer investment recommendations subject to the client's written approval. Discretionary accounts consist of a mixture of instruments bearing varying degrees of market, credit, and liquidity risk that should be appropriate to the client's investment objectives and risk appetite. Both account types are governed under separate agreements between the client and the institution.

Unlike depository accounts, securities and other instruments held in the client's investment accounts are not reflected on the balance sheet of the institution because they belong to the client. These managed assets are usually accounted for on a separate ledger that is segregated by the customer who owns the assets. For regulatory reporting, domestic trust departments and foreign trust departments of U.S. banks are required to report trust assets annually using FFIEC Form 001 (Annual Report of Trust Assets) and FFIEC Form 006 (Annual Report of International Fiduciary Activities). On the other hand, the fiduciary activities of foreign banking organizations operating in the United States currently are not reported on any FFIEC regulatory report.

Credit

Private-banking clients may request extensions of credit either on a secured or unsecured basis. Loans backed by cash collateral or managed assets held by the private-banking function are quite common, especially in international private banking. Private-banking clients may pledge a wide range of their assets, including cash, mortgages, marketable securities, land, or buildings, to securitize their loans. Management should demonstrate an understanding of the purpose of the credit, the source of repayment, and loan tenor as well as the collateral used in the financing. When lending to individuals with high net worths, whether on a secured or unsecured basis, the creditworthiness determination is bolstered by a thorough and well-structured KYC process. If that process is not thorough, collateral derived from illicit activities may be subject to government forfeiture.

Payable-Through Accounts

Another product that may be seen in privatebanking operations is payable-through accounts (PTAs). PTAs are transaction deposit accounts through which U.S. banking entities ("payablethrough banks") extend check-writing privileges to the customers of a foreign bank. The foreign bank ("master account holder") opens a master checking account with the U.S. bank and uses this account to provide its customers access to the U.S. banking system. The master account is divided into "subaccounts," each in the name of one of the foreign bank's customers. The foreign bank extends signature authority on its master account to its own customers, who may not be known to the U.S. bank. Consequently, the U.S. bank may have customers who have not been subject to the same account-opening requirements imposed on its U.S. account holders. These subaccount customers are able to write checks and make deposits at the U.S. banking entity. The number of subaccounts permitted under this arrangement may be virtually unlimited.

U.S. banking entities engage in PTAs primarily because they attract dollar deposits from the domestic market of their foreign correspondents without changing the primary bank/customer relationship; PTAs also provide substantial fee income. Generally, PTAs at U.S. banking entities have the following characteristics: they are carried out on the U.S. banking entity's books as a correspondent bank account, their transaction volume is high, checks passing through the account contain wording similar to "payable through XYZ bank," and the signatures appearing on checks are not those of authorized officers of the foreign bank.

Personal Trust and Estates

Trust and estate accounts offer management services for assets. When dealing with trusts under will, or "testamentary trusts," the institution may receive an estate appointment (executor) and a trustee appointment if the will provided for the trust from the probate. These accounts are fully funded at origination with no opportunity for an outside party to add to the account, and all activities are subject to review by the probate or surrogates' court. On the other

hand, with living trusts, or "grantor trusts," the customer (grantor) may continually add to and, in some instances, has control over the corpus of the account. Trusts and estates require experienced attorneys, money managers, and generally well-rounded professionals to set up and maintain the accounts. In certain cases, bankers may need to manage a customer's closely held business or sole proprietorship. In the case of offshore trust facilities, recent changes in U.S. law have imposed additional obligations on those banks who function as trustees or corporate management for offshore trusts and PICs.

A critical element in offering personal trust and estate services is the fiduciary responsibility of the institutions to their customers. This responsibility requires that institutions always act in the best interest of the clients pursuant to the trust documentation, perhaps even to the detriment of the bank. In these accounts, the bank is the fiduciary and the trust officer serves as a representative of the institution. Fiduciaries are held to higher standards of conduct than other bankers. Proper administration of trusts and estates includes strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping.

Custody Services

Custodial services offered to private-banking customers include securities safekeeping, receipts and disbursements of dividends and interest, recordkeeping, and accounting. Custody relationships can be established in many ways, including by referrals from other departments in the bank or from outside investment advisors. The customer, or a designated financial advisor, retains full control of the investment management of the property subject to the custodianship. Sales and purchases of assets are made by instruction from the customer, and cash disbursements are prearranged or as instructed. Custody accounts involve no investment supervision and no discretion. However, the custodian may be responsible for certain losses if it fails to act properly according to the custody agreement. Therefore, procedures for proper administration should be established and reviewed.

An escrow account is a form of custody account in which the institution agrees to hold

cash or securities as a middleman, or third party. The customer, who may be an attorney or travel agency, gives the institution funds to hold until the ultimate receiver of the funds "performs" in accordance with the written escrow agreement, at which time the institution releases the funds to the designated party.

Funds Transfer

Funds transfer, another service offered by private-banking functions, may involve the transfer of funds between third parties as part of bill-paying and investment services on the basis of customer instructions. The adequacy of controls over funds-transfer instructions that are initiated electronically or telephonically, such as by facsimile machine, telex, telegram, and telephone, are extremely important. Funds-transfer requests are quickly processed and, as required by law, funds-transfer personnel may have limited knowledge of the customers or the purpose of the transactions. Therefore, strong controls and adequate supervision over this area are critical.

Hold Mail

Hold-mail, or no-mail, accounts are often provided to private-banking customers who elect to have bank statements and other documents maintained at the institution rather than mailed to their residence. Agreements for all hold-mail accounts should be in place, and they should indicate that it was the customer's choice to have the statements retained at the bank and that the customer will pick up his or her mail at least annually. Variations of hold-mail services include delivery of mail to a prearranged location (such as another branch of the bank) by special courier or the bank's pouch system.

Bill-Paying Services

Bill-paying services are often provided to private-banking customers for a fee. If this service is provided, an agreement between the bank and the customer should exist. Typically, a customer might request that the bank debit a deposit account for credit card bills, utilities, rent, mortgage payments, or other monthly consumer charges.

FUNCTIONAL REVIEW

When discussing the functional aspects of a private-banking operation, "functional" refers to managerial processes and procedures, such as reporting lines, quality of supervision (including involvement of the board of directors), information flows, policies and procedures, riskmanagement policies and methodologies, segregation of duties, management information systems, operational controls, and audit coverage. The examiner should be able to draw sound conclusions about the quality and culture of management and stated private-banking policies after reviewing the functional areas described below. Specifically, the institution's riskidentification process and risk appetite should be carefully defined and assessed. Additionally, the effectiveness of the overall control environment maintained by management should be evaluated by an internal or external audit. The effectiveness of the following functional areas is critical to any private-banking operation, regardless of its size or product offerings.

Supervision and Organization

As part of the examiner's appraisal of an organization, the quality of supervision of privatebanking activities is evaluated. The appraisal of management covers the full range of functions and activities related to the operation of the private bank. The discharge of responsibilities by bank directors should be effected through an organizational plan that accommodates the volume and business services handled, local business practices and the bank's competition, and the growth and development of the institution's private-banking business. Organizational planning is the joint responsibility of senior bank and private-bank management and should be integrated with the long-range plan for the institution.

Both the directors and management have important roles in formulating policies and establishing programs for private-banking products, operations, internal controls, and audits. However, management alone must implement policies and programs within the organizational framework instituted by the board of directors.

Risk Management

Sound risk-management processes and strong internal controls are critical to safe and sound banking generally and to private-banking activities in particular. Management's role in ensuring the integrity of these processes has become increasingly important as new products and technologies are introduced. Similarly, the clientselection, documentation, approval, and accountmonitoring processes should adhere to sound and well-identified practices.

The quality of risk-management practices and internal controls is given significant weight in the evaluation of management and the overall condition of private-banking operations. A bank's failure to establish and maintain a riskmanagement framework that effectively identifies, measures, monitors, and controls the risks associated with products and services should be considered unsafe and unsound conduct. Furthermore, well-defined management practices should indicate the types of clients that the institution will accept and not accept and should establish multiple and segregated levels of authorization for accepting new clients. Institutions that follow sound practices will be better positioned to design and deliver products and services that match their clients' legitimate needs, while reducing the likelihood that unsuitable clients might enter their client account base. Deficiencies noted in this area are weighted in context of the relative risk they pose to the institution and are appropriately reflected in the appraisal of management.

The private-banking function is exposed to a number of risks, including reputational, fiduciary, legal, credit, operational, and market. A brief description of some of the different types of risks follows:

- Reputational risk is the potential that negative publicity regarding an institution's business practices and clients, whether true or not, could cause a decline in the customer base. costly litigation, or revenue reductions.
- Fiduciary risk refers to the risk of loss due to the institution's failure to exercise loyalty; safeguard assets; and, for trusts, to use assets

productively and according to the appropriate standard of care. This risk generally exists in an institution to the extent that it exercises discretion in managing assets on behalf of a customer.

- · Legal risk arises from the potential of unenforceable contracts, client lawsuits, or adverse judgments to disrupt or otherwise negatively affect the operations or condition of a banking organization. One key dimension of legal risk is supervisory action that could result in costly fines or other punitive measures being levied against an institution for compliance break-
- Credit risk arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- Operational risk arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.

Although effective management of all of the above risks is critical for an institution, certain aspects of reputational, legal, and fiduciary risks are often unique to a private-banking function. In this regard, the following KYC policies and practices are essential in the management of reputational and legal risks in the privatebanking functions. (In addition, sound fiduciary practices and conflicts-of-interest issues that a private-banking operation may face in acting as fiduciary are described in the subsection on fiduciary standards.)

Know-Your-Customer Policy and Procedures

Sound KYC policies and procedures are essential to minimize the risks inherent in private banking. They should clearly describe the target client base in terms such as minimum investable net worth and types of products sought, as well as specifically indicate the type of clientele the institution will or will not accept. They should be designed to ensure that effective due diligence is performed on all potential clients, that client files are bolstered with additional KYC information on an ongoing basis, and that clientaccount activity is monitored for transactions that are inconsistent with the client profile and may constitute unlawful activities, such as money laundering. The client's identity, background, and the nature of his or her transactions should be documented and approved by the back office before opening an account or accepting client monies. Certain high-risk clients like foreign politicians or money exchange houses should have additional documentation to mitigate their higher risk.

Money laundering is associated with a broad range of illicit activities: the ultimate intention is to disguise the money's true source—from the initial placement of illegally derived cash proceeds to the layers of financial transactions that disguise the audit trail—and make the funds appear legitimate. Under U.S. money-laundering statutes, a bank employee can be held personally liable if he or she is deemed to engage in "willful blindness." This condition occurs when the employee fails to make reasonable inquiries to satisfy suspicions about client-account activities.

Since the key element of an effective KYC policy is a comprehensive knowledge of the client, the bank's policies and procedures should clearly reflect the controls needed to ensure the policy is fully implemented. KYC policies should clearly delineate the accountability and authority for opening accounts and for determining if effective KYC practices and due diligence have been performed on each client. In addition, policies should delineate due diligence, documentation standards, and accountability for gathering client information from referrals among departments or areas within the institution as well as from accounts brought to the institution by new RMs.

In carrying out prudent KYC practices and due-diligence efforts on potential private-banking customers, management should document efforts to obtain and corroborate critical background information. Private-banking employees abroad often have local contacts who can assist in corroborating information received from the customer. The information listed below should be corroborated by a reliable independent source, when possible:

- The customer's current address and telephone number for his or her primary residence, which should be corroborated at regular intervals, can be verified through a variety of methods, such as—
 - visiting the residence, office, factory, or farm (with the RM recording the results

- of the visit or conversations in a memorandum);
- checking the information against the telephone directory; the client's residence, as indicated on his or her national ID card; a mortgage or bank statement or utility or property tax bill; or the electoral or tax rolls;
- obtaining a reference from the client's government or known employer or from another bank;
- checking with a credit bureau or professional corroboration organization; or
- any other method verified by the RM.
- Sufficient business information about the customer should be gathered so that the RM understands the profile of the customer's commercial transactions. This information should include a description of the nature of the customer's business operations or means of generating income, primary trade or business areas, and major clients and their geographic locations, as well as the primary business address and telephone number. These items can be obtained through a combination of any of the following sources:
 - a visit to the office, factory or farm
 - a reliable third party who has a business relationship with the customer
 - financial statements
 - Dun and Bradstreet reports
 - newspaper or magazine articles
 - Lexis/Nexis reports on the customer or customer's business
 - "Who's Who" reports from the home country
 - private investigations
- Although it is often not possible to get proof of a client's wealth, an RM can use his or her good judgment to derive a reasonable estimate of the individual's net worth.
- As part of the ongoing KYC process, the RM should document in "call reports" the substance of discussions that take place during frequent visits with the client. Additional information about a client's wealth, business, or other interests provides insight into potential marketing opportunities for the RM and the bank, and updates and strengthens the KYC profile.

As a rule, most private banks make it a policy not to accept "walk-ins." If an exception is made, procedures for the necessary documentation and approvals supporting the exception should be in place. Similarly, other exceptions to policy and procedures should readily identify the specific exception and the required duediligence and approval process to override existing procedures.

In most instances, all KYC information and documentation should be maintained and available for examination and inspection at the location where the account is located or where the financial services are rendered. If the bank maintains centralized customer files in locations other than where the account is located or the financial services are rendered, complete customer information, identification, and documentation must be made available at the location where the account is located or where the financial services are rendered within 48 hours of a Federal Reserve examiner's request. Offsite storage of KYC information will be allowed only if the bank has adopted, as part of its "Know Your Customer Program," specific procedures designed to ensure that (1) the accounts are subject to ongoing Office of Foreign Assets Control screening that is equivalent to the screening afforded other accounts, (2) the accounts are subject to the same degree of review for suspicious activity, and (3) the bank demonstrates that the appropriate review of the information and documentation is being performed by personnel at the offshore location.

KYC procedures should be no different when the institution deals with a financial advisor or other type of intermediary acting on behalf of a client. To perform its KYC responsibilities when dealing with a financial advisor, the institution should identify the beneficial owner of the account (usually the intermediary's client, but in rare cases, it is the intermediary itself) and perform its KYC analysis with respect to that beneficial owner. The imposition of an intermediary between the institution and counterparty should not lessen the institution's KYC responsibilities.

The purpose of all private-banking relationships should also be readily identified. Incoming customer funds may be used for various purposes such as establishing deposit accounts, funding investments, or establishing trusts. The bank's KYC procedures should allow for the collection of sufficient information to develop a "transaction/client profile" for each customer to be used in analyzing client transactions. Internal systems should be developed for monitoring and identifying transactions that may be inconsistent with the customer's transaction/client profile and may thus constitute suspicious activity.

Suspicious-activity reports. The proper and timely filing of suspicious-activity reports (SARs) is an important component of the bank's KYC program. Under the SAR regulations, banks must report any suspicious transaction relevant to a possible violation of law or regulation if the transaction is-

conducted or attempted, by, at or through a bank, involves \$5,000 or more, and, the bank knows, suspects or has reason to suspect either: the transaction involves funds from illegal activities or is conducted in order to hide or disguise assets; is designed to evade Bank Secrecy Act ("BSA") record keeping or reporting requirements; or the transaction has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

The concept of "reason to suspect" implies that bank liability is incurred for failing to file an SAR if it did not exercise due diligence in monitoring the account or in determining the true identity of the customer. The bank's internal systems for capturing suspicious activities should provide essential information about the nature and volume of activities passing through customer accounts. It is important that any information suggesting that suspicious activity has occurred be pursued, and, if an explanation is not forthcoming, the matter should be reported to bank management. Examiners should ensure that the bank's approach to SARs is proactive and that well-established procedures cover the SAR process. Accountability should exist within the organization for the analysis and follow-up of internally identified suspicious activity, which concludes with a decision on the appropriateness of filing an SAR. Examiners should see sections 902 and 1002 of the Bank Secrecy Act Manual for specific procedures on identifying suspicious activities related to teller and wiretransfer functions.

Credit

The underwriting standards for private-banking loans to high net worth individuals should be consistent with prudent lending standards. The same credit policies and procedures that are applicable to any other type of lending arrangement should extend to these loans. At a minimum, sound policies and procedures should address the following: all approved credit products and services offered by the institution, lending limits, acceptable forms of collateral, geographic and other limitations, conditions under which credit is granted, repayment terms, maximum tenor, loan authority, collections and charge-offs, and prohibition against capitalization of interest.

An extension of credit based solely on collateral, even if the collateral is cash, does not ensure repayment. While the collateral enhances the bank's position, it should not substitute for regular credit analyses and prudent lending practices. If collateral is derived from illegal activities, it is subject to forfeiture through the seizure of assets by a government agency. The bank should perform its due diligence by adequately and reasonably ascertaining and documenting that the funds of its private-banking customers were derived from legitimate means. Banks should also verify that the use of the loan proceeds is for legitimate purposes.

In addition, bank policies should explicitly describe the terms under which "margin loans," loans collateralized by securities, are made and should ensure that they conform to applicable regulations. Management should review and approve daily MIS reports. The risk of market deterioration in the value of the underlying collateral may subject the lender to loss if the collateral must be liquidated to repay the loan. In the event of a "margin call," any shortage should be paid for promptly by the customer from other sources pursuant to the terms of the margin agreement.

In addition, policies should address the acceptance of collateral held at another location, such as an affiliated entity, but pledged to the private-banking function. Under these circumstances, management of the private-banking function should, at a minimum, receive frequent reports detailing the collateral type and current valuation. In addition, management of the private-banking function should be informed of any changes or substitutions in collateral.

Fiduciary Standards

Fiduciary risk is managed through the maintenance of an effective and accountable committee structure; retention of technically proficient staff; and the development of effective policies, procedures, and controls. In managing its fiduciary risk, the bank must ensure that it carries out the following fiduciary duties:

- Duty of loyalty. Trustees are obligated to make all decisions based exclusively on the best interests of trust customers. Except as permitted by law, trustees cannot place themselves in a position in which their interests might conflict with those of the trust beneficiaries.
- · Avoidance of conflicts of interest. Conflicts of interest arise in any transaction in which the fiduciary simultaneously represents the interests of multiple parties (including its own interests) which may be adverse to one another. Institutions should have detailed policies and procedures regarding potential conflicts of interests. All potential conflicts identified should be brought to the attention of management and the trust committee, with appropriate action taken. Conflicts of interest may exist in any part of the institution but are most prevalent in trust or investment management departments. Consequently, management throughout the institution should receive training in these matters.
- Duty to prudently manage discretionary trust and agency assets. Since 1994, the majority of states have adopted laws concerning the prudent investor rule (PIR) with respect to the investment of funds in a fiduciary capacity. PIR is a standard of review that imposes an obligation to prudently manage the portfolio as a whole, focusing on the process of portfolio management, rather than on the outcome of individual investment decisions. Although this rule only governs trusts, this standard is traditionally applied to all accounts for which the institution is managing funds.

Operational Controls

To minimize any operational risks associated with private-banking activities, management is responsible for establishing an effective internal control infrastructure and reliable management information systems. Critical operational controls over any private-banking activity include the establishment of written policies and procedures, segregation of duties, and comprehensive management reporting. Throughout this manual, specific guidelines and examination procedures for assessing internal controls over different private-banking activities are provided. Listed below are some of those guidelines which cover specific private-banking services.

Segregation of Duties

Banking organizations should have guidelines on the segregation of employees' duties to prevent the unauthorized waiver of documentation requirements, poorly documented referrals, and overlooked suspicious activities. Independent oversight by the back office helps to ensure compliance with account-opening procedures and KYC documentation. Control-conscious institutions may use independent units such as compliance, risk management, or senior management to fill this function in lieu of the back office. The audit and compliance functions of the private bank should be similarly independent so that they can operate autonomously from line management.

Inactive and Dormant Accounts

Management should be aware that banking laws in most states prohibit banks from offering services that allow deposit accounts to be inactive for prolonged periods of time (12 or more months with no externally generated accountbalance activity). These regulations are based on the presumption that inactive and dormant accounts may be subject to manipulation and abuse by insiders. Policies and procedures should delineate when inactivity occurs and when inactive accounts should be converted to dormant status. Effective controls over dormant accounts should include a specified time between the last customer-originated activity and its classification as dormant, segregation of signature cards for dormant accounts, dual controls of records, and blocking of the account so that entries cannot be posted to the account without review by more than one member of senior management.

Pass-Through Accounts and Omnibus Accounts

Pass-through accounts (PTAs) extend checkingaccount privileges to the customers of a foreign bank; several risks are involved in providing these accounts. In particular, if the U.S. banking entity does not exercise the same due diligence and customer vetting for PTAs as it does for domestic account relationships, the use of PTAs may facilitate unsafe and unsound banking practices or illegal activities, including money laundering. Additionally, if accounts at U.S. banking entities are used for illegal purposes, the entities could be exposed to reputational risk and risk of financial loss due to asset seizures and forfeitures brought by law enforcement authorities. As stated in SR-95-10, it is recommended that U.S. banking entities terminate a payablethrough arrangement with a foreign bank in situations in which (1) adequate information about the ultimate users of PTAs cannot be obtained, (2) the foreign bank cannot be relied on to identify and monitor the transactions of its own customers, or (3) the U.S. banking entity is unable to ensure that its payable-through accounts are not being used for money-laundering or other illicit purposes.

"Omnibus," or general clearing, accounts may also exist in the private-banking system. They may be used to accommodate client funds before an account opening to expedite a new relationship, or they may fund products such as mutual funds in which client deposit accounts may not be required. However, these accounts could circumvent an audit trail of client transactions. Examiners should carefully review a bank's use of such accounts and the adequacy of its controls surrounding their appropriate use. Generally, client monies should flow through client deposit accounts, which should function as the sole conduit and paper trail for client transactions.

Hold Mail

Controls over hold mail are critical because the clients have relinquished their ability to detect unauthorized transactions in their accounts in a timely manner. Accounts with high volume or significant losses warrant further inquiry. Holdmail operations should ensure that client accounts are subject to dual control and are reviewed by an independent party.

Funds Transfer

One way that institutions can improve their customer knowledge is by tracking the transaction flows into and out of customer accounts and payable-through subaccounts. Tracking should include funds-transfer activities. Policies and procedures to detect unusual or suspicious activities should identify the types of activities that would prompt staff to investigate the customer's activities, and provide guidance on the appropriate action required for suspicious activity. The following is a checklist to guide bank personnel in identifying some potential abuses:

- indications of frequent overrides of established approval authority or other internal controls
- intentional circumvention of approval authority by splitting transactions
- wire transfers to and from known secrecy jurisdictions
- frequent or large wire transfers for persons who have no account relationship with the bank, or funds being transferred into and out of an omnibus or general clearing account instead of the client's deposit account
- wire transfers involving cash amounts in excess of \$10,000
- inadequate control of password access
- customer complaints or frequent error conditions

Custody

Custody departments should monitor account activity to detect instances of "free-riding," the practice of offering the purchase of securities without sufficient capital and then using the proceeds of the sale of the same securities to cover the initial purchase. Free-riding poses significant risk to the institution and typically occurs without the bank's prior knowledge. Free-riding also violates margin rules (Regulations T, U, and X) governing the extension of credit in connection with securities transactions.

Management Information Systems

Management information systems (MIS) should accumulate, interpret, and communicate infor-

mation on (1) the private-banking assets under management, (2) profitability, (3) business and transaction activities, and (4) inherent risks. The form and content of MIS for private-banking activities will be a function of the size and complexity of the private-banking organization. Accurate, informative, and timely reports that perform the following functions may be prepared and reviewed by RMs and senior management:

- aggregate the assets under management according to customer, product or service, geographic area, and business unit
- attribute revenue according to customer and product type
- identify customer accounts that are related or affiliated with one another through common ownership or common control
- identify and aggregate customer accounts by source of referral
- identify beneficial ownership of trust, PIC, and similar accounts

To monitor and report transaction activity and to detect suspicious transactions, management reports may be developed to—

- monitor a specific transaction criterion, such as a minimum dollar amount or volume or activity level;
- monitor a certain type of transaction, such as one with a particular pattern;
- monitor individual customer accounts for variations from established transaction and activity profiles based on what is usual or expected for that customer; and
- monitor specific transactions for BSA and SAR compliance.

In addition, reports prepared for privatebanking customers should be accurate, timely, and informative. Regular reports and statements prepared for private-banking customers should adequately and accurately describe the application of their funds and detail all transactions and activity that pertain to the customers' accounts.

Furthermore, MIS and technology play a role in building new and more direct channels of information between the institution and its private-banking customers. Active and sophisticated customers are increasing their demand for data relevant to their investment needs, which is fostering the creation of on-line information

services. Such on-line information can satisfy customers' desire for convenience, real-time access to information, and a seamless delivery of information.

Audit

An effective audit function is vital to ensuring the strength of a private bank's internal controls. As a matter of practice, internal and external auditors should be independently verifying and confirming that the framework of internal controls is being maintained and operated in a manner that adequately addresses the risks associated with the activities of the organization. Critical elements of an effective internal audit function are the strong qualifications and expertise of the internal audit staff and a sound risk-assessment process for determining the scope and frequency of specific audits. The audit process should be risk-focused and should ultimately determine the risk rating of business lines and client KYC procedures. Compliance with KYC policies and procedures and the detailed testing of files for KYC documentation are also key elements of the audit function. Finally, examiners should review and evaluate management's responsiveness to criticisms by the audit function.

Compliance

The responsibility for ensuring effective compliance with relevant laws and regulations may vary among different forms of institutions, depending on their size, complexity, and availability of resources. Some institutions may have a distinct compliance department with the centralized role of ensuring compliance institutionwide, including private-banking activities. This arrangement is strongly preferable to a situation in which an institution delegates compliance to specific functions, which may result in the management of private-banking operations being responsible for its own internal review. Compliance has a critical role in monitoring privatebanking activities; the function should be independent of line management. In addition to ensuring compliance with various laws and regulations such as the Bank Secrecy Act and those promulgated by the Office of Foreign Assets Control, compliance may perform its

own internal investigations and due diligence on employees, customers, and third parties with whom the bank has contracted in a consulting or referral capacity and whose behavior, activities, and transactions appear to be unusual or suspicious. Institutions may also find it beneficial for compliance to review and authorize account-opening documentation and KYC adequacy for new accounts. The role of compliance is a control function, but it should not be a substitute for regular and frequent internal audit coverage of the private-banking function. Following is a description of certain regulations that may be monitored by the compliance function.

Office of Foreign Assets Control

The function of the Office of Foreign Assets Control (OFAC) in the U.S. Department of the Treasury is to promulgate and administer regulations dealing with the economic sanctions that the U.S. government imposes against certain foreign countries and the "specially designated nationals" of those countries. Under the International Emergency Economic Powers Act, the president can impose sanctions such as trade embargoes, freezing of assets, and import surcharges on these entities.

A "specially designated national" is a person or entity who acts on behalf of one of the countries under economic sanction by the United States. Dealing with such nationals is prohibited. Moreover, their assets or accounts in the United States are frozen. In certain cases, the Treasury Department can issue a license to a designated national. This license can then be presented by the customer to the institution, allowing the institution to debit his or her account. The license can be either general or specific.

OFAC screening may be difficult when transactions are conducted through PICs, token names, numbered accounts, or other vehicles that shield true identities. Management must ensure that accounts maintained in a name other than that of the beneficial owner are subject to the same level of filtering for OFAC specially designated nationals and blocked foreign countries as other accounts. That is, the OFAC screening process must include the account's beneficial ownership as well as the official account name.

Any violation of regulations implementing designated national sanctions subjects the violator to criminal prosecution, including up to 12 years in prison and \$1 million in corporate fines and \$250,000 in individual fines, per incident. Any funds frozen because of OFAC orders should be placed in a blocked account. Release of those funds cannot occur without a license from the Treasury Department.

Bank Secrecy Act

Guidelines for compliance with the Bank Secrecy Act (BSA) can be found in the Federal Reserve System's Bank Secrecy Act Examination Manual. In addition, the procedures for conducting BSA examinations of foreign offices of U.S. banks are detailed in SR-96-5.

PREPARATION FOR **EXAMINATION**

The following subsections provide examiners with guidance on preparing for the on-site examination of private-banking operations, including determination of the examination scope and drafting of the first-day-letter questionnaire that is provided to the institution.

Pre-Examination Review

To prepare the examiners for their assignments, and to determine the appropriate staffing and scope of the examination, the following guidelines should be followed during the preexamination planning process:

- Review the prior report of examination and workpapers for the exam scope; structure and type of private-banking activities conducted; and findings, conclusions, and recommendations of the prior examination. The prior examination report and examination plan should also provide insight to key contacts at the institution and to the timeframe of the prior private-banking review.
- Obtain relevant correspondence sent since the prior examination, such as management's response to the report of examination, any applications submitted to the Federal Reserve, and any supervisory action.

- · Research press releases and published news stories about the institution and its privatebanking activities.
- · Review internal and external audit reports and any internal risk assessments performed by the institution on its private-banking activities. Such reports should include an assessment of the internal controls and risk profile of the private-banking function.
- · Contact management at the institution to ascertain what changes have occurred since the last exam or are planned in the near future. For example, have there been changes to the strategic plan; senior management; or the level and type of private-banking activities, products, and services offered? If there is no mention of private banking in the prior examination report, management should be asked at this time if they have commenced or plan to commence any private-banking activities.

Examination Staffing and Scope

Once the exam scope has been established and before beginning the new examination, the examiner-in-charge and key administrators of the examination team should meet to discuss the private-banking examination scope, the assignments of the functional areas of private banking, and the supplemental reviews of specific privatebanking products and services. If the bank's business lines and services overlap, and its customer base and personnel are shared throughout the organization, examiners may be forced to go beyond a rudimentary review of privatebanking operations. They will probably need to focus on the policies, practices, and risks within the different divisions of a particular institution and throughout the institution's global network of affiliated entities.

Reflection of Organizational Structure

The review of private-banking activities should be conducted on the basis of the financial institution's organizational structure. These structures may vary considerably depending on the size and sophistication of the institution, its country of origin and the other geographic markets in which it competes, and the objectives and strategies of its management and board of directors. To the extent possible, examiners should understand the level of consolidated private-banking activities an institution conducts in the United States and abroad. This broad view is needed to maintain the "big picture" impact of private banking for a particular institution

Risk-Focused Approach

Examiners reviewing the private-banking operations should implement the "risk-focused" examination approach. The exam scope and degree of testing of private-banking practices should reflect the degree of risk assumed, prior exam findings on the implementation of policies and procedures, the effectiveness of controls, and an assessment of the adequacy of the internal audit and compliance functions. If initial inquiries into the institution's internal audit and other assessment practices raise doubts about the internal system's effectiveness, expanded analysis and review are required—and examiners should perform more transaction testing.

First-Day Letter

As part of the examination preparation, examiners should customize the first-day-letter (FDL) questionnaire to reflect the structure and type of private-banking activities of the institution and the scope of the exam. The following is a list of requests regarding private banking that examiners should consider including in the FDL. Responses to these items should be reviewed in conjunction with responses to the BSA, fiduciary, audit, and internal control inquiries:

- organizational chart for the private bank on both a functional and legal-entity basis
- · business and/or strategic plan
- income and expense statements for the prior fiscal year and current year to date, with projections for the remainder of the current

- and the next fiscal year, and income by product division and marketing region
- balance sheet and total assets under management (list the most active and profitable accounts by type, customer domicile, and responsible account officer)
- most recent audits for private-banking activities
- · copies of audit committee minutes
- copy of the KYC and SAR policies and procedures
- list of all new business initiatives introduced last year and this year, relevant new-productapproval documentation that addresses the evaluation of the unique characteristics and risk associated with the new activity and/or product, and an assessment of the riskmanagement oversight and control infrastructures in place to manage the risks
- list of all accounts in which an intermediary is acting on behalf of clients of the private bank, for example, as financial advisors or money managers
- explanation of the methodology for following up on outstanding account documentation and a sample report
- description of the method for aggregating client holdings and activities across business units throughout the organization
- explanation of how related accounts, such as common control and family link, are identified
- name of a contact person for information on compensation, training, and recruiting programs for relationship managers
- list of all personal investment company accounts
- list of reports that senior management receives regularly on private-banking activities
- description and sample of the management information reports that monitor account activity
- description of how senior management monitors compliance with global policies for worldwide operations, particularly for offices operating in secrecy jurisdictions
- copies of any SARs filed since the last examination

Private-Banking Activities Examination Objectives

Effective date May 1998

Section 4128.2

- To determine if the policies, practices, procedures, and internal controls regarding private-banking activities are adequate.
- To determine if bank officers and employees are operating in conformance with the bank's established guidelines.
- 3. To assess the financial condition of the private-banking activities.
- 4. To determine the scope and adequacy of the audit function.
- 5. To determine compliance with applicable laws and regulations.
- To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations are noted.

INTRODUCTION

The Securities Act of 1933 requires that adequate and reliable information be made available about securities originally offered for sale to the public. The act requires registration of any sale with the Securities and Exchange Commission (SEC) unless it is specifically exempted. Section 4(2) of the act exempts "transactions by an issuer not involving any public offering." That exemption created a type of business in the securities industry known as "private placements."

Securities placed privately have certain advantages and disadvantages for both investor and issuer. Through negotiation, both parties may tailor the offering to meet their needs. The issuer saves securities registration costs and obtains alternative financing. The investor makes an investment for a specified length of time at a stated rate of return. Both investor and issuer complete the transaction without being subject to regulatory and public scrutiny.

The major disadvantage of private placements to the investor is the general lack of a secondary market. Thus, the investor may be unable to liquidate the holding until maturity. Additionally, the investor must rely on her or his own expertise when deciding on a purchase. Unlike registered securities, private placements are not reviewed by the SEC. A disadvantage to the issuer is the limitation on the amount of capital that may be raised since the number of investors is usually small. Moreover, advisory fees may be high relative to the size of the issue.

The matching of issuers with investors is usually done by an individual or firm acting as either an agent or an advisor. In the agent relationship, the firm has authority to commit the issuer. An advisor has no such power. Regardless of whether the firm is agent or advisor, it must act prudently and disclose all pertinent information to the investor. Furthermore, the firm must avoid possible conflicts of interest. Agents, usually investment bankers, participate in negotiations between the issuer and investor, and their fee is dependent on their involvement. Agreements between the firm and all other parties should specifically state whom the firm represents as agent.

In 1974, the SEC classified what constitutes an offering exempted from its registration requirements through the issuance of Rule 146.

An offering may be a private placement, under that rule, if the following minimum criteria are met:

- The securities are purchased by no more than 35 persons. A person purchasing at least \$150,000 of an offering need not be counted in the number of purchasers.
- There is no general advertising and no oral or written solicitation of persons other than eligible offerees.
- The securities are offered and sold only to those persons who the issuer believes are (1) sufficiently experienced to evaluate the merits and risks of the investment or (2) able to bear the risk of the investment. Before the sale, purchasers should have the services of an experienced representative.
- Each offeree either has access to or is furnished with the type of information that would be supplied in a registration statement.
- The issuer takes certain specified steps to ensure that the securities are not resold by the purchasers, except according to the rules governing resales.

When all requirements of Rule 146 are met, an offering may still be subject to registration if it is part of a plan to evade SEC registration provisions. The restrictions placed on commercial banks for the private placement of commercial paper are discussed in "Bank Dealer Activities," section 2030.

PRIVATE-PLACEMENT ACTIVITIES BY BANKS

A commercial bank's board of directors assumes additional responsibilities when private-placement services are offered. Private-placement activities, like any other banking function, should be subject to adequate safeguards and policy considerations. When drafting a policy, the board of directors should ensure that self-dealing practices or conflict-of-interest charges cannot develop. Procedures should be developed to monitor private-placement activity whenever such services are provided by the bank or a subsidiary. Moreover, procedures should be in effect to detect any transactions that could have an adverse effect on the bank's other functions, such as loan or trust department activities.

4130.1 Private Placements

A bank acting as advisor or agent assumes the risk of a potential conflict-of-interest charge whenever the proceeds from the placement are used to reduce a criticized loan at the bank. Furthermore, the bank must exercise due diligence to disclose relevant information, especially if the issuer is borrowing from the bank and is experiencing financial difficulty. Although the bank may not commit funds in a private-placement transaction, the potential for financial loss or damage to its reputation does exist if

the bank does not prudently deal with all parties to the transaction by disclosing all relevant facts.

The examiner should evaluate the bank's involvement and expertise in private-placement activities by reviewing policies, practices, and procedures. The examiner should also check for compliance with applicable laws and regulations and determine if any significant loss exposure or risk could result from the bank's involvement in private placement.

Private Placements Examination Objectives

Effective date May 1996

Section 4130.2

- To determine if policies, practices, procedures, and internal controls for private placements are adequate and prudent.
- To determine if bank officers and employees are operating in conformance with established guidelines.
- 3. To determine the scope and adequacy of the audit function.
- To evaluate the overall effectiveness and quality of bank management in advising and completing private placements.
- To initiate corrective action when policies, practices, procedures, or internal controls are deficient.

Examination Procedures

Effective date March 1984

- If selected for implementation, complete or update the Private Placements section of the Internal Control Questionnaire.
- Based upon the evaluation of internal controls and the work performed by internal/ external auditors, determine the scope of the examination.
- Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors and determine if corrections have been accomplished.
- 4. Request the following information from appropriate personnel:
 - a. A list of all private placements advised by the bank since the last examination to include:
 - · Name of issuer.
 - Name of investor(s), including banks.
 - · Fee and how it was determined.
 - · Amount, rate, maturity of issue.
 - b. A list of any funds managed by the bank or its trust department, subsidiaries or affilates that have been used to purchase private placements advised by the bank or an affiliate.
 - A letter from bank counsel regarding legality of the bank's involvement in private placement activities.
 - d. A list of the person(s) performing private placement advisory services and their previous experience.
 - A list of investors that the bank normally deals with in placing private offerings and their stated investment requirements.
 - f. A copy of the bank's standard form agreements used in private placement transactions.
 - g. A list of any borrowers whose loans were partially or fully repaid from the

- sale of private placements advised by the bank since the last examination.
- A list of participations purchased or sold in loans used to fund private placements advised by the bank.
- Review pertinent information received in performing step 4 and compare it to the list of criticized assets from the previous examination.
- Forward list of placements to the examiner assigned loan portfolio management and request that he or she determine if any loans were made to fund the investment in the private placement.
- Review opinions of legal counsel regarding private placements and determine if there are any material deficiencies.
- Determine if former banking relationships exist for both issuer and investor and determine if fees charged for loans or paid on deposits are within normal bank policy.
- 9. Review files related to a representative sample of all placement transactions and determine if the bank evaluates both the issuer and investor in a private placement transaction, including the suitability of the investment to the stated investment requirements of the investor.
- 10. Confer with examiner assigned "Duties and Responsibilities of Directors" and determine if potential conflicts of interest exist between bank-advised placements and interests of directors and principal officers.
- Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
 - a. Deficiencies in policies, practices and internal controls.
 - b. Any hazardous or potentially hazardous placement activities.
 - c. Recommended corrective action.
- 12. Update the workpapers with any information that will facilitate future examinations.

Private Placements

Internal Control Questionnaire

Effective date March 1984

Section 4130.4

Review the bank's internal controls, policies, practices and procedures for private placement activities. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

POLICIES

- Does the bank, bank subsidiary(s) or affiliate(s) provide private placement advisory services?
- 2. Has the board of directors adopted written policies for private placement activities that:
 - a. Define objectives?
 - b. Provide guidelines for fee determinations based on:
 - Size of transaction?
 - Anticipated degree of difficulty or time involved?
 - Payment of negotiated fees at various stages of the transaction?

and not solely on:

- Deposits on balances or the profitabity of the client's other banking relationships?
- Successful completion of the transaction?
- c. Require that bank officers act in an advisory rather than agent capacity in all negotiations?

(An advisor will advise and assist a client, an agent has the authority to commit a client.)

- d. Recognize possible conflicts of interest and establish appropriate procedures regarding:
 - The purchase of bank-advised private

- placements with funds managed by the bank or an advisory affiliate?
- Loans to investors to purchase private placements?
- Use of proceeds of an advised placement to repay the issuer's debts to the bank?
- Dealings with unsophisticated or noninstitutional investors who have other business relationships with the bank?
- e. Require legal review of each placement prior to completion?
- f. Direct officers to obtain certified financial statements from the seller?
- g. Require distribution of certified financial statements to interested investors?
- h. Require officers to request a written statement of investment objectives or requirements from interested investors?
- i. Provide for a supervisory management review to determine if a placement is suitable for the investor?

CONCLUSION

- 3. Is the foregoing information considered adequate as the basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
- Based on a composite evaluation as evidenced by answers to the foregoing questions, the degree of control by main office management is considered (adequate/inadequate).

INTRODUCTION

The bank failures of the late 1980s caused a rapid depletion of the deposit insurance fund, and despite the poor financial condition of the banking industry during that time, there was a prevailing belief that at least a portion of the cost of resolving bank failures could have been avoided if troubled depository institutions had been dealt with in a more efficient, timely, and consistent manner. Because of this belief. Congress developed a new regulatory framework in 1991 with the intent of minimizing the longterm cost to the deposit insurance fund. This legislation led to the enactment of the promptcorrective-action statute, which is contained in section 131 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and added section 38 to the Federal Deposit Insurance Act (FDIA), as amended (12 USC

Section 38 requires regulators to administer timely corrective action to banks when their capital position declines or is deemed to have declined below certain threshold levels as a result of an unsafe or unsound condition or practice. The prompt-corrective-action (PCA) framework specifies mandatory actions that regulators must take, as well as discretionary actions they must consider taking.

In order to implement PCA as it applies to state member banks, the Federal Reserve added a new subpart B to its Regulation H (12 CFR 208). The Federal Reserve also revised its Rules of Practice for Hearings (12 CFR 263) to establish procedures for the issuance of notices, directives, and other actions authorized under section 38 of the FDIA and Regulation H.

PCA utilizes capital ratios to trigger specific actions that are designed to restore a bank to financial health. One of the primary sources of these ratios is the Consolidated Reports of Condition and Income (call report), which gives added importance to the review of a bank's records for accuracy during an examination. Under the PCA statute a bank is assigned to one of five capital categories: (1) well capitalized, (2) adequately capitalized, (3) undercapitalized, (4) significantly undercapitalized, and (5) critically undercapitalized. The law provides for increasingly stringent corrective provisions as a bank is placed in progressively lower capital categories.

PCA CATEGORIES

PCA uses the total risk-based capital, tier 1 risk-based capital, leverage, and tangible equity ratios for assigning state member banks to the five capital categories. These ratios are defined in the Federal Reserve's Capital Adequacy Guidelines for State Member Banks, appendix A (Risk-Based Measure) and appendix B (Tier 1 Leverage Measure) (12 CFR 208). Determining a bank's PCA category is based upon capital ratios derived from the following: (1) the filing of a quarterly call report, (2) receipt of a Federal Reserve or state examination report, (3) information obtained in the application process, or (4) other reports filed by the bank under banking or securities laws.

In general, a bank is deemed to be notified of its PCA category based upon the time of its submission or receipt of—

- the call report, as of the date the call report is required to be filed,
- the Federal Reserve or state examination report, as of the third day following the date of the transmittal letter accompanying the examination report, and
- other information, upon the bank's receipt of written notice that its category has been changed.

Notifying a bank of its PCA category is important since any bank falling in the undercapitalized or lower categories is subject to certain mandatory provisions, and may be subject to certain discretionary provisions, immediately upon notification that it is undercapitalized, significantly undercapitalized, or critically undercapitalized. These mandatory and discretionary provisions are described in detail later.

Each PCA category is described below. See the table at the end of this section for a summary of framework definitions. A bank is—

^{1.} The total risk-based capital ratio is defined as total capital to risk-weighted assets; the tier 1 capital ratio is the ratio of tier 1 capital to risk-weighted assets; the leverage ratio is the ratio of tier 1 capital to total average assets; and the tangible equity ratio is defined as core capital elements plus cumulative perpetual preferred stock, net of all intangible assets except those amounts of purchased mortgage servicing rights allowable in tier 1 capital. See the manual section on Assessment of Capital Adequacy for additional information.

- well capitalized if the bank has a total risk-based capital ratio of 10.0 percent or greater, a
 tier 1 risk-based capital ratio of 6.0 percent or
 greater, and a leverage ratio of 5.0 percent or
 greater, and the bank is not subject to an order,
 written agreement, capital directive, or promptcorrective-action directive to meet and maintain a specific capital level for any of the
 prompt-corrective-action measures.
- adequately capitalized if the bank has a total risk-based capital ratio of 8.0 percent or greater, a tier 1 risk-based capital ratio of 4.0 percent or greater, and a leverage ratio of 4.0 percent or greater (or a leverage ratio of 3.0 percent or greater if the bank is rated composite 1 in its most recent report of examination), and the bank does not qualify as well capitalized.
- *undercapitalized* if the bank has a total risk-based capital ratio that is less than 8.0 percent, a tier 1 risk-based capital ratio that is less than 4.0 percent, or a leverage ratio that is less than 4.0 percent (or a leverage ratio that is less than 3.0 percent if the bank is rated composite 1 in its most recent report of examination).
- *significantly undercapitalized* if the bank has a total risk-based capital ratio that is less than 6.0 percent, a tier 1 risk-based capital ratio that is less than 3.0 percent, or a leverage ratio that is less than 3.0 percent.
- *critically undercapitalized* if the bank has a ratio of tangible equity to total assets that is equal to or less than 2.0 percent.

EXAMINATION CONSIDERATIONS

If it is determined a bank is undercapitalized, significantly undercapitalized, or critically undercapitalized, examiners should discuss the PCA provisions with management during the examination. Additionally, examiners should caution banks when their capital ratios approach those found in the undercapitalized category to ensure that proposed dividend or management fee payments do not cause the bank to violate the statute. Any PCA-related comments should be noted on the Examination Comments and Conclusions page of the examination report and in the Summary to Directors of Examination Findings report. The comments should be limited to the mandatory provisions of the statute, reflect the immediacy of these provisions, and clearly indicate that the receipt of the report of examination serves as notification that the bank is subject to PCA provisions.

Capital Adequacy Page

In the report of examination, the PCA capital ratios appear on the Capital Adequacy page and are generally calculated using the bank's most recent call report. In situations where the impact of examination findings (for example, loan loss reserve adjustments or other losses) cause the bank to fall into a lower PCA category, the narrative portion of this page should explicitly state the adjusted PCA ratios and reconcile the adjustments that were made.

RECLASSIFICATION

A bank's PCA category is normally defined by its capital ratios indicated in the preceding definitions. The finding of an unsafe or unsound condition or practice, however, may lead to a bank's reclassification to the next lower category than it would otherwise qualify for based solely on its capital ratios. In these circumstances, the Federal Reserve may—

- reclassify a well-capitalized bank to the adequately capitalized category.
- require an adequately capitalized bank to comply with one or more supervisory provisions specified by PCA for an undercapitalized bank.
- impose on an undercapitalized bank one or more supervisory actions authorized for a significantly undercapitalized bank.

While the latter two actions do not strictly represent reclassifications from one category to another, they are nonetheless collectively referred to as "reclassifications" for PCA purposes.

Thus, section 38 does not make a bank that has been reclassified to the next lower capital category automatically subject to the mandatory restrictions of the lower category. These mandatory restrictions can only be imposed through the use of a directive and only those mandatory and discretionary provisions deemed appropriate by the Federal Reserve will be imposed. A bank can only be reclassified to the next lower capital category and cannot be classified as critically undercapitalized on any basis other than its tangible equity ratio.

The reclassification of a bank for PCA purposes may affect the bank's ability to accept brokered deposits. If a well- or adequately capitalized bank is reclassified, the bank must obtain an FDIC waiver to accept brokered deposits, regardless of its actual capital level. (The manual section on Deposit Accounts contains a detailed discussion on the capital requirements relating to brokered deposit activities.)

An "unsafe or unsound condition" is not defined in the PCA statute and assessment thereof is left to the discretion of the Federal Reserve. Banks determined to be in an unsafe or unsound condition based on the results of the most recent report of examination or call report will be reclassified. On the other hand, an "unsafe or unsound practice" is defined as a less-than-satisfactory rating for any of the AMEL (asset quality, management, earnings, or liquidity) components in the bank's most recent examination report that have not been corrected since the examination. In particular, a bank should be considered for reclassification if the imposition of the available PCA provisions would assist the return of the bank to a safe or sound condition or institute safe or sound practices.

The Federal Reserve recognizes that certain banks that are candidates for reclassification may have taken favorable actions that are consistent with the purposes of PCA. In these cases, reclassification may not be warranted—

- if the bank has raised or can demonstrate current efforts to raise enough capital to become and remain well capitalized for the foreseeable future; and
- if the bank has attempted to be in substantial compliance with all provisions of any outstanding informal or formal enforcement action; if management is addressing existing problems and is considered satisfactory; and if the bank's condition is stable and shows signs of improvement.

In those instances where reclassification is determined to be appropriate, the Federal Reserve will provide the bank with a written notice specifying its intention to reclassify the bank, along with an explanation of the reasons for the downgrade. The date of the reclassification and the required PCA provisions can be made effective either at a specified future date or, under certain circumstances, immediately, at the discretion of the Federal Reserve. An

appeals process exists in both situations; it is described in greater detail in the subsection on Issuance of PCA Directives.

PCA PROVISIONS

Provisions Applicable to All Banks

While well-capitalized and adequately capitalized banks are generally not subject to any restrictions, they are subject to two provisions that are applicable to all banks:

- A bank may not pay dividends or make any other capital distributions that would leave it undercapitalized.²
- A bank may not pay a management fee to a controlling person if, after paying the fee, the bank would be undercapitalized. Management fees subject to this restriction are those relating to overhead expenses and managerial, supervisory, executive, or policymaking functions, other than compensation to an individual in the individual's capacity as an officer or employee of the bank. This does not include fees relating to nonmanagerial services provided by the controlling person, such as data processing, trust activities, mortgage services, audit and accounting, property management, or similar services.

Restrictions on Advertising

The Federal Reserve prohibits a bank from advertising its PCA category. A bank may not describe itself in an advertisement or in promotional material as falling within the well-capitalized category, nor may the bank advertise that the Federal Reserve has determined it to be well capitalized. However, a bank is not restricted from advertising its capital levels or financial condition.

^{2.} Section 38 contains a limited exception to the dividend restriction for certain types of stock redemptions that (1) the Federal Reserve has approved, (2) are made in connection with an equivalent issue of additional shares or obligations, and (3) will improve the bank s financial condition. The Federal Reserve may also impose dividend restrictions on any company that controls a significantly undercapitalized bank.

Provisions Applicable to Undercapitalized Banks

A bank categorized as undercapitalized is subject to several *mandatory* provisions that become effective upon notification of the bank. Under the mandatory provisions, an undercapitalized bank—

- · must cease paying dividends.
- is prohibited from paying management fees to a controlling person (see the previous subsection for exceptions).
- is subject to increased monitoring by the Federal Reserve and periodic review of the bank's efforts to restore its capital.
- must file and implement a capital restoration plan generally within 45 days. Undercapitalized banks that fail to submit or implement a capital restoration plan are also subject to the provisions applicable to significantly undercapitalized banks.
- may acquire interest in a company, open any new branch offices, or engage in a new line of business only if the following three requirements are met:
 - the Federal Reserve has accepted its capital restoration plan,
 - any increase in total assets is consistent with the capital restoration plan, and
 - the bank's ratio of tangible equity to assets increases during the calendar quarter at a rate sufficient to enable the bank to become adequately capitalized within a reasonable time.
- may not make any acquisition, acquire any company or depository institution, establish new branches, or engage in any new line of business unless the Federal Reserve determines that such action is consistent with its capital plan or the FDIC determines that such action will further the purposes of PCA.

In addition to the mandatory provisions, a number of *discretionary* provisions may be imposed on an undercapitalized bank. These include—

- requiring one or more of the following:
 - That the bank sell enough additional capital or debt to ensure that it would be adequately capitalized after the sale.
 - That the aforementioned additional capital be voting shares.

- That the bank accept an offer to be acquired by another institution or company, or that any company that controls the bank be required to divest itself of the bank.
- restricting transactions between the bank and its affiliates.
- restricting the interest rates paid on deposits collected by the bank to the prevailing rates paid on comparable amounts in the region where the bank is located.
- restricting the bank's asset growth or requiring the bank to reduce its total assets.
- requiring the bank or any of its subsidiaries to terminate, reduce, or alter any activity determined by the Federal Reserve to pose excessive risk to the bank.
- ordering a new election of the board of directors, dismissing certain senior executive officers, or hiring new officers.
- prohibiting the acceptance, renewal, and rollover of deposits from correspondent depository institutions.
- prohibiting any bank holding company that controls the bank from making any capital distribution, including but not limited to dividend payment, without the prior approval of the Federal Reserve.
- requiring the bank to divest or liquidate any subsidiary that is in danger of becoming insolvent and that poses a significant risk to the bank, or is likely to cause significant dissipation of its assets or earnings.
- requiring any company that controls the bank to divest or liquidate any affiliate of the bank (other than another insured depository institution) if the Federal Reserve determines that the affiliate is in danger of becoming insolvent and poses a significant risk to the bank, or is likely to cause significant dissipation of the bank's assets or earnings.
- requiring the bank to take any other action that would more effectively carry out the purpose of PCA than the above actions.

Provisions Applicable to Significantly Undercapitalized Banks

The mandatory restrictions applicable to undercapitalized banks also apply to banks that are significantly undercapitalized. In addition, a significantly undercapitalized bank is restricted in paying bonuses or raises to senior executive officers of the bank unless it receives prior written approval from the Federal Reserve. If a bank fails to submit an acceptable capital restoration plan, however, no such bonuses or raises may be paid until an acceptable plan has been submitted.

The Federal Reserve, as directed by the PCA statute, must take the following actions unless it is determined that these actions would not further the purpose of PCA:

- Require one or more of the following:
 - That the bank sell enough additional capital or debt to ensure that it would be adequately capitalized after the sale.
 - That the aforementioned additional capital be voting shares.
 - That the bank accept an offer to be acquired by another institution or company, or that any company that controls the bank be required to divest itself of the bank.
- Restrict the bank's transactions with affiliates.
- Restrict the interest rates paid on deposits collected by the bank to the prevailing rates paid on comparable amounts in the region where the bank is located.

In addition to these mandatory provisions, one or more of the discretionary provisions for undercapitalized banks must be imposed on a significantly undercapitalized bank. Moreover, other measures (including the provisions for critically undercapitalized banks) may be required if the Federal Reserve determines that such actions will advance the purposes of PCA.

Provisions Applicable to Critically Undercapitalized Banks

A critically undercapitalized bank must be placed in conservatorship (with the concurrence of the FDIC) or receivership within 90 days, unless the Federal Reserve and the FDIC concur that other action would better achieve the purposes of PCA. The decision to defer placing a critically undercapitalized bank in conservatorship or receivership must be reviewed every 90 days, and an explanation must be provided about why deferring this decision would better achieve the purposes of the statute (preventing losses to the bank insurance fund).

A bank must be placed in receivership if it continues to be critically undercapitalized on

average³ during the fourth calendar quarter following the period that it initially became critically undercapitalized, unless the following specific requirements are met:

- The bank has a positive net worth.
- The bank has been in substantial compliance with its capital restoration plan since the date of the plan's approval.
- The bank is profitable or has a sustainable upward trend in earnings.
- The bank has reduced its ratio of nonperforming loans to total loans.
- The Chairman of the Federal Reserve and the chairperson of the FDIC both certify that the bank is viable and not expected to fail.

Critically undercapitalized banks are also prohibited, beginning 60 days after becoming critically undercapitalized, from making any payment of principal or interest on subordinated debt issued by the bank without the prior approval of the FDIC. Unpaid interest, however, may continue to accrue on subordinated debt under the terms of the debt instrument. The FDIC is also required, at a minimum, to prohibit a critically undercapitalized bank from doing any of the following without the prior written approval of the FDIC:

- Entering into any material transaction not in the usual course of business. Such activities include any investment, expansion, acquisition, sale of assets, or other similar action where the bank would have to notify the Federal Reserve.
- Extending credit for any highly leveraged transaction.
- Amending the bank's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order.
- Making any material change in accounting methods.
- Engaging in any covered transaction under section 23A(b) of the Federal Reserve Act.
- Paying excessive compensation or bonuses.
- Paying interest on new or renewed liabilities that would increase the bank's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest paid

^{3.} This is determined by adding the sum of the total tangible equity ratio at the close of business on each day during this quarter and dividing that sum by the number of business days in that quarter.

on insured deposits in the bank's normal market area.

Capital Restoration Plans

A bank that is undercapitalized, significantly undercapitalized, or critically undercapitalized must submit a capital restoration plan to the Federal Reserve. The plan should aim to restore the bank's capital to at least the minimum capital levels required for adequately capitalized banks. This plan must be submitted in writing and specify—

- the steps the bank will take to become adequately capitalized.
- the levels of capital the bank expects to attain in each year that the plan is in effect.
- how the bank will comply with the restrictions and requirements imposed on it under section 38.
- the types and levels of activities in which the bank will engage.
- any other information required by the Federal Reserve.

A capital restoration plan cannot be accepted unless the plan—

- contains the information required in the preceding five points.
- is based on realistic assumptions and is likely to succeed in restoring the bank's capital.
- would not appreciably increase the risk (including credit risk, interest-rate risk, and other types of risk) to which the bank is exposed.
- contains a guarantee from each company that controls the bank, specifying that the bank will comply with the plan until it has been adequately capitalized on average during each of four consecutive calendar quarters, and each company has provided appropriate assurances of performance. (See the subsequent subsection, Capital Restoration Plan Guarantee, for additional information.)

Submission and Review of Capital Plans

The Federal Reserve has established rules regarding a uniform schedule for the filing and review of capital restoration plans. These rules

require a bank to submit a capital restoration plan within 45 days after the bank has received notice, or has been deemed to have been notified, that it is undercapitalized, significantly undercapitalized, or critically undercapitalized. The Federal Reserve may change this period in individual cases, provided it notifies the bank that a different schedule has been adopted. PCA also requires the Federal Reserve to—

- review each capital restoration plan within 60 days of submission of the plan unless it extends the review time.
- provide written notice to the bank about whether it has approved or rejected the capital plan.
- provide a copy of each acceptable capital restoration plan, and amendments thereto, to the FDIC within 45 days of accepting the plan.

There are two cases where a capital restoration plan may not be required:

- When a bank has capital ratios consistent with those corresponding to the adequately capitalized category but, due to unsafe or unsound conditions or practices, has been reclassified to the undercapitalized category.
- When a bank's capital category changes, but the bank is already operating under a capital restoration plan accepted by the Federal Reserve.

The Federal Reserve will examine the circumstances of each of the above cases to determine whether a revised plan must be submitted.

Capital Restoration Plan Guarantee

The Federal Reserve cannot approve a capital restoration plan unless each company that controls the bank has guaranteed the bank's compliance with the plan and has provided reasonable assurances of performance. The Federal Reserve will consider on a case-by-case basis the appropriate type of guarantee for multi-tier holding companies, or parent holding companies that are shell companies or that have limited resources. A guarantee that is backed by a contractual pledge of resources from a parent company may satisfy the requirements of section 38, particularly in situations involving the ownership of an insured bank by a foreign

company through a wholly owned domestic shell holding. In other situations, a third-party guarantee made by a party with adequate financial resources may be satisfactory.

PCA also contains several provisions that clarify the capital restoration plan guarantee:

- Limitation on liability. The aggregate amount of liability under the guarantee for all companies that control a specific bank is limited to the lesser of (1) an amount equal to 5 percent of the bank's total assets, or (2) the amount necessary to restore the relevant capital ratios of the bank to the level required for the bank to be categorized as adequately capitalized.
- Limitation on duration. The guarantee and limit on liability expires after the Federal Reserve notifies the bank that it has remained adequately capitalized for each of the previous four consecutive calendar quarters.
- Collection of guarantee. Each company that controls a given bank is jointly and severally liable for the guarantee.
- Failure to provide a guarantee. A bank will be treated as if it had not submitted an acceptable capital restoration plan if its capital plan does not contain the required guarantee.
- Failure to perform under a guarantee. A bank will be treated as if it failed to implement the capital restoration plan if any company that controls the bank fails to perform its guarantee.

Failure to Submit an Acceptable Capital Plan

An undercapitalized bank that fails to submit or implement, in any material respect, an acceptable capital restoration plan within the required period is subject to the same provisions applicable to a bank that is significantly undercapitalized. If a bank's capital restoration plan is rejected, the bank is required to submit a new capital plan within the time period specified by the Federal Reserve. During the period following notice of the rejection, and before Federal Reserve approval of a new or revised capital plan, the bank is treated in the same manner as a significantly undercapitalized bank.

ISSUANCE OF PCA DIRECTIVES

The Federal Reserve must provide a state mem-

ber bank, or company controlling a state member bank (company), a written notice of proposed action under section 38 (referred to as a directive), unless the circumstances of a particular case indicate that immediate action is necessary to serve the purpose of PCA. These directives are issued for reasons such as reclassifying a bank and implementing discretionary provisions, the latter of which includes the dismissal of directors or senior executive officers.

A notice of intent to issue a directive should include—

- a statement of the bank's capital measures and levels.
- a description of the restrictions, prohibitions, or affirmative actions that the Federal Reserve proposes to impose or require.
- the proposed date when such restrictions or prohibitions would be effective or the proposed date for completion of such affirmative actions.
- the date by which the bank or company subject to the directive may file with the Federal Reserve a written response to the notice.

When a directive becomes effective at a future date, the Federal Reserve must provide the bank or company an opportunity to appeal the directive before taking final action. This requires the bank to submit information relevant to the decision within the time period set by the Federal Reserve, which must be at least 14 calendar days from the date of the notice, unless the Federal Reserve determines that a shorter period is appropriate in light of the financial condition of the bank or other relevant circumstances. In either case, a decision must be rendered within 60 calendar days of the receipt of the appeal.

In the case of a directive that is immediately effective upon notification of the bank, the Federal Reserve's rules provide an opportunity for the bank or company to seek an expedited modification or rescission of the directive. A bank or company that appeals a directive effective immediately is required to file a written appeal within 14 days of receiving the notice, and the Federal Reserve must rule on the appeal within 60 days of receiving it. During the period that the appeal is under review the directive remains in effect, unless the effectiveness of the directive is delayed by the Federal Reserve.

Part of the appeal process includes the bank's right to an informal hearing. This hearing is conducted by a representative selected by the Federal Reserve and permits oral testimony or witnesses. This request for a hearing should accompany the bank's response to notification of a PCA directive, and the Federal Reserve must generally issue an order for the hearing to commence no later than 30 days after receipt of the bank's request. The presiding officer at the hearing must make a recommendation to the Federal Reserve regarding the bank's appeal within 20 calendar days of the closing of the record of the hearing proceeding. The Federal Reserve must then issue a decision within 60 calendar days of the date of the closing of the hearing record. Any bank that has been reclassified or subjected to a PCA directive may, upon a change in circumstances, request in writing that the Federal Reserve reconsider the terms of the directive, and may propose that the directive be modified, rescinded, or removed. The directives issued will remain in place while the request is pending unless otherwise ordered by the Federal Reserve.

Dismissal of Directors or Senior Executive Officers

The Federal Reserve's rules establish a special procedure permitting an opportunity for senior executive officers and directors dismissed from

a state member bank as a result of a PCA directive to petition for reinstatement. A director or senior executive officer who is required to be dismissed in compliance with a Federal Reserve directive may have the dismissal reviewed by filing, within 10 days, a petition for reinstatement with the Federal Reserve. The petitioner will also be given the opportunity to submit written materials in support of the petition and to appear at an informal hearing before representatives of the Federal Reserve. The date for the hearing and for the ultimate decision follows the same timeframe as that indicated for the appeals process in the preceding paragraph.

Enforcement of Directives

PCA directives may be enforced in the federal courts, and may cause any bank, company, or bank-affiliated party that violates the directive to be subject to civil money penalties. The failure of a bank to implement a capital restoration plan, or the failure of a company having control of a state member bank to fulfill a guarantee that the company has given in connection with a capital plan accepted by the Federal Reserve, could subject the bank or company or any of their bank-affiliated parties to a civil money penalty assessment.

TABLE—SUMMARY OF SPECIFICATIONS OF CAPITAL CATEGORIES FOR PROMPT CORRECTIVE ACTION

Capital category	Total risk-based ratio	Tier 1 risk-based ratio	Leverage ratio	Additional criteria
Well capitalized	10% or above; plus	6% or above; plus	5% or above; plus	is not subject to a capital direc- tive to meet a specific level for any capital measure
Adequately capitalized	8% or above; plus	4% or above; plus	4% or above; 1 plus	does not meet the definition of well capitalized
Under- capitalized	under 8%; or	under 4%; or	under 4% ²	
Significantly under- capitalized	under 6%; or	under 3%; or	under 3%	
Critically under- capitalized	not applicable	not applicable	not applicable	can only be assigned to this category if the ratio of tangible equity to total assets is equal to or less than 2% ³

^{1.} Three percent or above for banks rated composite 1 in their most recent report of examination and that are not experiencing or anticipating significant growth.

^{2.} Under 3 percent for banks rated composite 1 in their most recent report of examination and that are not experiencing or anticipating significant growth.

^{3.} Tangible equity is defined as core capital elements plus cumulative perpetual preferred stock, net of all intangible assets except those amounts of purchased mortgage-servicing rights allowable into tier 1 capital.

Prompt Corrective Action Examination Objectives

Effective date November 1994

Section 4133.2

- 1. To determine if prompt-corrective-action (PCA) provisions are necessary.
- To determine if the policies, practices, and procedures are in place to ensure compliance with PCA mandatory and discretionary provisions.
- To ensure that undercapitalized, significantly undercapitalized, and critically undercapitalized banks have effective capital restoration plans that comply with PCA.

INTRODUCTION

The Board has a longstanding policy on real estate appraisals that emphasizes the importance of sound appraisal policies and procedures in a bank's real estate lending activity. In December 1987 the Board and the other banking regulatory agencies jointly adopted guidelines for real estate appraisal policies and review procedures. With the passage of title XI of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, the Board as well as the other federal financial institutions regulatory agencies adopted in August 1990 regulations regarding the performance and utilization of appraisals by federally regulated financial institutions. In September 1992 the Board issued revised guidelines for real estate appraisal and evaluation programs, which were later amended on June 7, 1994.

The intent of title XI and the Board's regulation is to protect federal financial and public policy interests in real estate-related financial transactions requiring the services of an appraiser. Title XI also requires that real estate appraisals be in writing and be performed in accordance with uniform standards and by individuals with demonstrated competency whose professional conduct is subject to effective supervision. In this regard, title XI permitted each state to establish a program for certifying and licensing real estate appraisers who are qualified to perform appraisals in connection with federally related transactions. Additionally, title XI designated the Appraisal Foundation, a nonprofit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and standards for the performance of an appraisal. However, title XI left to the states the authority to establish qualification standards for licensing. Title XI established the Appraisal Subcommittee of the Federal Financial Institutions Examination Council (FFIEC) to monitor the requirements established to meet the intent of title XI.

Effective Date

The Board's appraisal regulation (Regulation H,

12 CFR 208)¹ requires that appraisals performed in connection with federally related transactions after the effective date of August 9, 1990, comply with the regulation. Appraisals for real estate–related financial transactions entered into before this date do not have to comply with the regulation. However, the bank would have had to adhere to the Board's supervisory guidelines, issued in 1987, for such real estate appraisals, as well as to safe and sound banking practices. Transactions are deemed to have been entered into and a loan is deemed to have been originated if there was a binding commitment to perform before the effective date.

The requirement to use a state-certified or -licensed appraiser had a separate effective date of January 1, 1992, but was extended by the FDIC Improvement Act of 1991 to no later than December 31, 1992. Consequently, states had the flexibility to adopt an earlier implementation date regarding state requirements that an appraiser be certified or licensed to perform an appraisal within their state. Financial institutions doing business in a state that had an earlier effective date for mandatory use of a certified or licensed appraiser than the federally mandated effective date would have had to abide by the state law.

BANK APPRAISAL AND EVALUATION POLICY

An institution's board of directors is responsible for adopting policies and procedures that establish effective real estate appraisal and evaluation programs. Analyzing real estate collateral at a loan's inception and over its life requires a sufficient understanding of appraisals and evaluations to fully assess credit risk. While the appraisal plays an important role in the loan approval process, the bank should not unduly rely on the collateral value in lieu of an adequate assessment of the borrower's repayment ability. However, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's capacity to repay to the value of the collateral. For these reasons, it is important that banks have sound appraisal policies and procedures.

^{1.} The standards applicable to appraisals are set forth in subpart G of the Board's Regulation Y, 12 CFR 225.

Appraisal and Evaluation Program

An institution's appraisal and evaluation program should be tailored to the institution's size, location, and the nature of its real estate market and attendant real estate-related activity. The program should establish prudent standards and procedures that ensure written appraisals or evaluations are obtained and analyzed for real estate-related financial transactions before the bank makes its final credit decision.

The bank's appraisal and evaluation program should also establish the manner in which the institution selects, evaluates, and monitors individuals who perform real estate appraisals or evaluations. The key elements of the institution's program should ensure that individuals are fairly considered for the assignment, possess the requisite expertise to satisfactorily complete the assignment, hold the proper state certification or license if applicable, and are capable of rendering a high-quality written appraisal or evaluation.

Compliance Procedures

To ensure the bank is complying with the regulation and supervisory guidelines, the bank should have established regulatory compliance procedures for all appraisals and evaluations. The compliance review may be part of a loan officer's overall credit analysis and may take the form of a narrative or a checklist. The individual who prepared the appraisal or evaluation should take corrective action for noted deficiencies. Unreliable appraisals or evaluations should be replaced before the final credit decision.

Additionally, a bank should have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential construction loans, or out-of-area real estate. These comprehensive analytical procedures should be designed to verify the appropriateness of the methods and approaches used and to assess the reasonableness of the analysis, opinions, and conclusions. The bank should maintain formal documentation or evidence of the review. An individual performing the review, either an employee of the bank or an outside consultant, should have real estate-related training or experience and be independent of the transaction. The individual may not change the

appraisal's or evaluation's estimate of value as a result of the review unless that person is appropriately licensed or certified and performs the review in accordance with the review procedures contained in the Uniform Standards of Professional Appraisal Practice (USPAP) Standard 3.

FEDERALLY RELATED FINANCIAL TRANSACTIONS

A federally related transaction is defined in title XI as a real estate-related financial transaction that a federal financial institutions regulatory agency engages in, contracts for, or regulates and that requires the services of an appraiser. Title XI further defines a real estaterelated financial transaction as any transaction involving the sale, lease, purchase, investment in, or exchange of real property, including interests in property, or the financing thereof; the refinancing of real property or interests in real property; or the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

The Board recognizes that not all real estaterelated financial transactions require the services of an appraiser. In this regard, the Board has determined that certain categories of real estaterelated financial transactions do not require the services of a certified or licensed appraiser and as such are not considered federally related transactions. However, for certain transactions that do not require a certified or licensed appraisal, an evaluation of the underlying collateral is required under the Board's supervisory guidelines.

Transaction Value

The transaction value is defined as the amount of the loan or extension of credit under consideration. For a pool of loans or a mortgagebacked security, the transaction value is the amount of each individual loan. In determining transaction value, the senior and junior debt are considered separate transactions under the appraisal rule. However, a series of related transactions will be considered as one transaction if it appears that an institution is attempting to avoid the appraisal requirement by structuring the transactions below the appraisal threshold.

Transactions Not Requiring the Services of a Licensed or Certified Appraiser

An appraisal performed by a state-certified or -licensed appraiser is required for all real estate-related financial transactions except those in which—

- the transaction value is \$250,000 or less;
- a lien on real estate has been taken as collateral in an abundance of caution;
- the transaction is not secured by real estate;
- a lien on real estate has been taken for purposes other than the real estate's value;
- the transaction is a business loan that has a transaction value of \$1 million or less and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
- a lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;
- the transaction involves an existing extension
 of credit at the lending institution, provided
 that there has been no obvious and material
 change in market conditions or physical
 aspects of the property that threatens the
 adequacy of the institution's real estate collateral protection after the transaction, even
 with the advancement of new monies, or there
 is no advancement of new monies, other than
 funds necessary to cover reasonable closing
 costs;
- the transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met the Board's regulatory requirements for appraisals at the time of origination;
- the transaction is wholly or partially insured or guaranteed by a U.S. government agency or U.S. government–sponsored agency;
- the transaction either qualifies for sale to a U.S. government agency or U.S. government sponsored agency, or involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;

- the regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law; or
- the Board determines that the services of an appraiser are not necessary to protect federal financial and public policy interests in real estate—related financial transactions or to protect the safety and soundness of the institution.

For transactions that do not require title XI appraisals because they are below the appraisal threshold or because they qualify for the \$1 million or less business-loan exemption or the existing extension-of-credit exemption, the Board still requires an appropriate evaluation of the real property collateral that is consistent with safe and sound banking practices.

The Board reserves the right to require a bank to obtain an appraisal on an exempt transaction whenever it is necessary to address safety-andsoundness concerns. Whether a bank will be required to obtain an appraisal for a particular transaction or an entire group of credits will depend on the condition of the bank. For example, if a bank is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the bank to obtain an appraisal for all new transactions below the threshold. However, regardless of a bank's condition, an examiner may require a bank to obtain an appraisal for a particular real estate-related transaction to address safety-and-soundness concerns.

Obtaining an Appraisal

The bank or its agent is responsible for engaging the appraiser and obtaining the appraisal in sufficient time to be analyzed before the bank arrives at its final credit or other decision. A bank may not accept an appraisal prepared for a potential borrower as the appraisal for a federally related transaction. However, a bank may use an appraisal prepared by an appraiser engaged directly by another regulated or non-regulated financial services institution as long as the bank has established procedures for reviewing appraisals, the review indicates that the appraisal meets the regulation, and the review is documented in writing.

For a multiphased development or construction loan, the appraisal of an earlier phase cannot be used for a new phase due to the change in risk to the bank. However, if the original appraisal was prepared for all phases of the project, the bank may use the project appraisal if the appraisal's value for the new phase is still valid at the time the bank extends the additional credit.

APPRAISAL REQUIREMENTS

The objective of an appraisal is to communicate the appraiser's reasoning and conclusions in a logical manner so that the reader is led to the appraiser's estimation of market value. The contents of appraisals should conform to the standards of the Board's appraisal regulation and the Uniform Standards of Professional Appraisal Practice (USPAP), promulgated by the Appraisal Standards Board of the Appraisal Foundation. The actual form, length, and content of appraisal reports may vary, depending on the type of property being appraised and the nature of the assignment. Standard forms completed in compliance with the rule and USPAP are also acceptable.

Appraisal Standards

Title XI prescribes the minimum standard for appraisals performed in connection with federally related transactions as those standards set forth in USPAP as well as any other appropriate standards that the Board deems necessary. At a minimum, the Board's appraisal regulation requires that an appraisal—

- conform to generally accepted appraisal standards as evidenced by USPAP, unless principles of safe and sound banking require compliance with stricter standards;
- be written and contain sufficient information and analysis to support the bank's decision to engage in the transaction;
- analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units;
- be based upon the definition of market value as set forth in the regulation; and
- be performed by state-licensed or -certified appraisers in accordance with the requirements in the regulation.

The Board's appraisal regulation also permits banks to use appraisals prepared in accordance with the USPAP Departure Provision. The Departure Provision permits limited exceptions to "specific guidelines" in USPAP. Appraisers preparing appraisals using the Departure Provision still must comply with all "binding requirements" of USPAP and must be sure that the resulting appraisal will not be misleading.

Appraisal Assignment

A bank may engage an appraiser to perform either a complete or a limited appraisal, referred to as an appraisal assignment. In a complete appraisal assignment, an appraiser must meet all USPAP standards and guidelines in estimating market value. In a limited appraisal assignment, the appraiser elects to depart from certain specific guidelines by invoking the Departure Provision. Before beginning the appraisal, the appraiser must obtain the bank's concurrence that the use of the Departure Provision is appropriate for the transaction. The appraiser must ensure that the resulting appraisal report will not mislead the bank or other intended users of the appraisal report. The bank should realize that, as the degree of departure increases, the corresponding level of reliability of the limited appraisal decreases, resulting in a higher level of risk.

Appraisal Reports

The appraisal report usually includes a disclosure of sales history and an opinion as to the highest value and best use of the property. After preparing a report, appraisers must certify that—

- statements of fact are true and correct;
- limiting conditions have been disclosed;
- they have no interest (present or future) in the transaction or property;
- compensation is not contingent on rendering a specified value;
- · they have complied with USPAP;
- an inspection of the property was or was not performed: and
- assistance was or was not received in the preparation of the appraisal.

There are three different report formats that can be used for both the complete and the limited appraisal assignment: a self-contained report, a summary report, and a restricted report. Since USPAP requires all appraisal reports to encompass all aspects of the assignment, differences among these reports relate to the degree of detail presented. The self-contained appraisal report provides the most detail; the summary appraisal report condenses the information; and the restricted appraisal report contains a minimal presentation of information with the supporting details maintained in the appraiser's work files.

The restricted report is not appropriate for a significant number of federally related transactions because the minimal amount of information limits the usefulness of the document for underwriting, compliance, and other decision-making purposes. However, it might be appropriate to use this type of appraisal report when providing ongoing collateral monitoring of a bank's real estate transactions and under other circumstances when a bank's program requires an evaluation.

Appraisal Content

The appraisal must reflect a market value of the real estate. The regulation defines market value as the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.

Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from the seller to the buyer under conditions whereby—

- buyer and seller are typically motivated;
- both parties are well informed or well advised, and acting in what they consider their own best interests;
- a reasonable time is allowed for exposure in the open market;
- payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
- the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

To properly underwrite a construction loan, a bank may need to know a prospective value of a property in addition to the market value as of the date of the appraisal. A prospective value is based upon events yet to occur, such as completion of construction or renovation, reaching stabilized occupancy, or some other event yet to be determined. Thus, more than one value may be reported in an appraisal as long as all values are clearly described and reflect the projected dates when future events could occur.

APPRAISAL VALUATION APPROACHES

The appraiser typically utilizes three marketvalue approaches to analyze the value of property:

- · cost approach
- market data or direct comparable sales approach
- capitalization of income approach

All three approaches have particular merits depending upon the type of real estate being appraised. For single-family residential property, the cost and comparable sales approaches are most frequently used since the common use of the property is the personal residence of the owner. However, if a single-family residential property is intended to be used as a rental property, the appraiser would have to consider the income approach as well. For special-use commercial properties, the appraiser may have difficulty obtaining sales data on comparable properties and may have to base the value estimate on the cost and capitalization of income approaches.

If an approach is not used in the appraisal, the appraiser should disclose the reason the approach was not used and whether this affects the value estimate.

Cost Approach

In the cost approach to value estimation, the appraiser obtains a preliminary indication of value by adding the estimated depreciated reproduction cost of the improvements to the estimated land value. This approach is based on the assumption that the reproduction cost is the upper limit of value and that a newly con-

structed building would have functional and mechanical advantages over an existing building. The appraiser would evaluate any functional depreciation (disadvantages or deficiencies) of the existing building in relation to a new structure.

The cost approach consists of four basic steps: (1) estimate the value of the land as though vacant, (2) estimate the current cost of reproducing the existing improvements, (3) estimate depreciation and deduct from the reproduction cost estimate, and (4) add the estimate of land value and the depreciated reproduction cost of improvements to determine the value estimate.

Market Data or Direct Comparable Sales Approach

The essence of the market data or direct comparable sales approach is to determine the price at which similar properties have recently sold on the local market. Through an appropriate adjustment for differences in the subject property and the selected comparable properties, the appraiser estimates the market value of the subject property based on the sales price of the comparable properties. The process used in determining the degree of comparability of two or more properties involves judgment about their similarity with respect to age, location, condition, construction, layout, and equipment. The sales price or list price of those properties deemed most comparable tend to set the range for the value of the subject property.

Capitalization of Income Approach

The income approach estimates the project's expected income over time converted to an estimate of its present value. The income approach is typically used to determine the market value of income-producing properties such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can use several different capitalization or discounted cash-flow techniques to arrive at a market value. These techniques include the band-of-investments method, mortgage-equity method, annuity method, and land-residual technique. Which technique is used depends on whether there is project financing,

whether there are long-term leases with fixedlevel payments, and whether the value is being rendered for a component of the project such as land or buildings.

The accuracy of the income-approach method depends on the appraiser's skill in estimating the anticipated future net income of the property and in selecting the appropriate capitalization rate and discounted cash-flow. The following data are assembled and analyzed to determine potential net income and value:

- Rent schedules and the percentage of occupancy for the subject property and for comparable properties for the current year and several preceding years. This provides gross rental data and shows the trend of rentals and occupancy, which are then analyzed by the appraiser to estimate the gross income the property should produce.
- Expense data such as taxes, insurance, and operating costs being paid from revenues derived from the subject property and by comparable properties. Historical trends in these expense items are also determined.
- A timeframe for achieving stabilized, or normal, occupancy and rent levels (also referred to as a holding period).

Basically, the income approach converts all expected future net operating income into present-value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is used to value income properties. This method calculates the value of a property by dividing an estimate of its stabilized annual income by a factor called a cap rate. Stabilized income is generally defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The cap rate usually defined for each property type in a market area—is viewed by some analysts as the required rate of return stated as a percent of current income.

The use of this technique assumes that the use of either the stabilized income or the cap rate accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and

direct capitalization should yield the same results.

For special-use properties, new projects, or troubled properties, the discounted cash flow (net present value) method is the more typical approach to analyzing a property's value. In this method, a timeframe for achieving a stabilized, or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Most importantly, the analysis should be based on the ability of the project to generate income over time based upon reasonable and supportable assumptions. Additionally, the discount rate should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions. For further discussion, see the manual section on Real Estate Loans.

Value Correlation

The three value estimates—cost, market, and income—must be evaluated by the appraiser and correlated into a final value estimate based on the appraiser's judgment. Correlation does not imply averaging the value estimates obtained by using the three different approaches. Where these value estimates are relatively close together, correlating them and setting the final market value estimate presents no special problem. It is in situations where widely divergent values are obtained by using the three appraisal approaches that the examiner must exercise judgment in analyzing the results and determining the estimate of market value.

Other Definitions of Value

While the Board's appraisal regulation requires that the appraisal contain the market value of the real estate collateral, there are other definitions of value that are encountered in appraising and evaluating real estate transactions. These include the following.

Fair Value. This is an accounting term that is generally defined as the amount in cash or cash-equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (the selling price), that is, other than in a forced or liquidation sale.² According to accounting literature, fair value is generally used in valuing assets in nonmonetary transactions, troubled debt restructuring, quasi-reorganizations, and business combinations accounted for by the purchase method. An accountant generally defines fair value as market value; however, depending on the circumstances, these values may not be the same for a particular property.

Investment Value. This is based on the data and assumptions that meet the criteria and objectives of a particular investor for a specific property or project. The investor's criteria and objectives are often substantially different from participants' criteria and objectives in a broader market. Thus, investment value can be significantly higher than market value in certain circumstances and should not be used in credit analysis decisions.

Liquidation Value. This assumes that there is little or no current demand for the property but the property needs to be disposed of quickly, resulting in the owner sacrificing potential property appreciation for an immediate sale.

Going-Concern Value. This is based on the value of a business entity rather than the value of just the real estate. The valuation is based on the existing operations of the business that has a proven operating record, with the assumption that the business will continue to operate.

Assessed Value. This represents the value on which a taxing authority bases its assessment. The assessed value and market value may differ considerably due to tax assessment laws, timing of reassessments, and tax exemptions allowed on properties or portions of a property.

FASB Statement of Standards No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," appendix A.

Net Realizable Value (NRV). This is recognized under generally accepted accounting principles as "the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal."3 The NRV is generally used to evaluate the carrying amount of assets being held for disposition and properties representing collateral. While the market value or future selling price are generally used as the basis for the NRV calculation, the NRV also reflects the current owner's costs to complete the project and to hold and dispose of the property. For this reason, the NRV will generally be less than the market value.

EVALUATION REQUIREMENTS

The Board's appraisal regulation allows banks to use evaluations for real estate-related financial transactions that do not require title XI appraisals for certain exempt transactions. Exempt transactions include—

- transactions below the \$250,000 threshold,
- transactions qualifying for the exemption for the business loans of \$1 million or less where income from real estate is not the primary source of repayment, and
- subsequent transactions resulting from an existing extension of credit (for example, renewals and refinancings).

An evaluation should provide a general estimate of the value of the real estate and need not meet the detailed requirements of a title XI appraisal.⁴ An evaluation must provide appropriate information to enable the bank to make a prudent decision regarding the transaction. Moreover, a bank is not precluded from obtaining an appraisal that conforms to the regulation for any exempt transaction.

At a minimum, an evaluation should-

 describe the real estate collateral, including its condition and current use,

- describe the source(s) of information used in the analysis.
- describe the analysis and supporting information, and
- provide an estimate of the real estate's market value, with any limiting conditions.

Form and Content of Evaluations

Since a bank must tailor evaluations to provide appropriate information for different types of transactions, the content and form of evaluations will vary for different transactions. The documentation for evaluations should fully support the estimate of value and include sufficient information to understand the analysis and assumptions. There is no requirement that the evaluation be based on a particular form or valuation approach, but the analysis should be applicable to the type of property and fully explain the value rendered.

Prudent practices require that as the bank's exposure in a real estate—related financial transaction increases, a more detailed evaluation should be performed. An evaluation for a transaction that needs a more detailed analysis should fully describe the property and discuss its use, especially for nonresidential property.

An evaluation for a transaction that requires a less-detailed analysis may be based upon information such as comparable property sales information from sales data services (for example, the multiple listing service) or current tax-assessed value in appropriate situations.⁵ An evaluation may also be based on the bank's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties where appraisals meeting the requirements of the regulation were obtained. Regardless of the method, the bank must document its analysis and findings in the loan file.

An evaluation must be in writing, signed, dated, and include the preparer's name and address. The evaluation should include a presentation of the calculations, supporting assumptions for the estimate of value, and, if utilized, a discussion of comparable property sales.

^{3.} FASB Statement of Standards No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," appendix A.

^{4.} An appraisal means the kind of specialized opinion as to the value of real estate, containing certain formal elements recognized by appraisal industry practices and standards.

^{5.} Because assessed values for tax purposes may be a specified fraction of market value as determined by the tax assessor, tax-assessed values should be adjusted to a market-value equivalent. In cases where the assessed value does not have a reliable correlation to current value, the use of assessed value would be inappropriate as the basis for an evaluation.

USEFUL LIFE OF APPRAISALS OR EVALUATIONS

Since a bank may wish to use an existing appraisal or evaluation for a subsequent loan or investment, the bank's appraisal and evaluation program should include criteria to determine the validity of an existing appraisal or evaluation. When deciding if an appraisal or evaluation may be used for a subsequent transaction, a bank should determine if there has been any material change to the underlying assumptions that would affect the original estimate of value.

The useful life of an appraisal or evaluation will vary depending upon the circumstances affecting the property and the marketplace. Examples of factors that could cause material changes to reported values include the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject or competing, surrounding properties; change in zoning; or environmental contamination.

The bank should document its information sources and analyses used to determine if an existing appraisal or evaluation remains valid and if the bank will be using the appraisal or evaluation in a subsequent transaction.

REAPPRAISALS OR REEVALUATIONS

Real estate formerly pledged as collateral to secure an extension of credit that has been acquired by a bank through foreclosure proceedings, or that has been deeded to the bank in lieu of foreclosure proceedings, qualifies for the appraisal exemption for existing extensions of credit. In these circumstances, although a bank is *not* required to obtain an appraisal, it is required to obtain an evaluation, generally before entering into the transaction. In the interest of protecting the value of its collateral, however, a bank may initiate foreclosure action and obtain the evaluation in a reasonable period of time after taking title to the property.

The bank should develop criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques—even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

The decision to reappraise or reevaluate the real estate collateral for a subsequent transaction should be guided by the appraisal exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends upon the condition and quality of the loan, the soundness of the underlying collateral, and the validity of the existing appraisal or evaluation.

A bank may renew or refinance a loan based on a valid appraisal or evaluation if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. However, if the property has reportedly appreciated because of a planned change in use, such as rezoning, an appraisal would be required for a federally related transaction unless another exemption applied, such as the amount financed is below the appraisal threshold.

While the Board's appraisal regulation generally allows appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds are advanced over reasonable closing costs, a bank would be expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions that threatens the bank's real estate collateral protection.

For loan workouts involving the modification of the terms and conditions of an existing extension of credit, including the acceptance of new or additional real estate collateral, that facilitates the orderly collection of the credit or reduces the bank's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs. In a troubled-loan situation, a reappraisal would not be required when a bank advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition.

QUALIFICATIONS CRITERIA FOR APPRAISERS AND INDIVIDUALS PERFORMING EVALUATIONS

The accuracy of an appraisal or evaluation

depends on the competence and integrity of the individual performing the appraisal or evaluation, as well as the individual's expertise at developing and interpreting pertinent data for the subject property. The individual should have adequate training, experience, and knowledge of the local real estate market to make sound judgments about the value of a particular property. The level of training, experience, and knowledge should be commensurate with the type and complexity of the property to be valued. Additionally, the individual should be independent of the credit decision, have no interest in the property being valued, and have no affiliations or associations with the potential borrower. Absent absolute lines of independence, a bank must be able to demonstrate that it has prudent safeguards in place to isolate its collateral-evaluation process from influence or interference from the loan-production process.

Appraiser Qualifications

Under title XI of FIRREA, two classifications of appraisers were identified to be used in federally related transactions: state-certified appraiser and state-licensed appraiser. For a certified appraiser, title XI contemplated that the states would adopt similar standards for certification based on the qualification criteria of the Appraiser Qualifications Board of the Appraisal Foundation. These standards set forth minimum educational, testing, experience, and continuing education requirements. For a licensed appraiser, the states have some latitude in establishing qualification standards provided that the criteria are adequate to protect federal financial and public policy interest.

The Appraisal Subcommittee of the FFIEC is responsible for monitoring the states for compliance with title XI. The Board also has the authority to impose additional certification and licensing requirements to those standards adopted by a given state.

Selection of an Appraiser

An independent appraisal is one in which the appraiser is not participating in the administration of the credit or in the approval of the transaction and has no interest, financial or

otherwise, in the property. In certain instances involving small banks, officers and directors who perform appraisals must take appropriate steps to ensure independence from the transaction under consideration.

In selecting an appraiser for an appraisal assignment, a bank is expected to consider whether the individual holds the proper state certification or license and has the appropriate experience and educational background to complete the assignment. Financial institutions may not exclude a qualified appraiser from consideration for an appraisal assignment solely because the appraiser lacks membership in a particular appraisal organization or does not hold a particular designation from an appraisal association, organization, or society.

In that regard, banks are expected to treat all appraisers fairly and equitably in determining whether the institution will use the services of a particular appraiser. Generally, banks have established procedures for selecting appraisers and maintaining an approved appraiser list. The practice of preapproving appraisers for ongoing appraisal work and maintaining an approved appraiser list is acceptable so long as all appraisers are required to follow the same approval process. However, a bank that requires appraisers who are not members of a particular appraisal organization to formally apply, pay an application fee, and submit samples of previous appraisal reports for review—but does not have identical requirements for appraisers who are members of certain appraisal organizations would be viewed as having a discriminatory selection process.

Appraisals Performed by Certified or Licensed Appraisers

A bank is required to use a certified appraiser for-

- all federally related transactions over \$1 million,
- nonresidential federally related transactions more than \$250,000, and
- complex residential federally related transactions more than \$250,000.6

^{6.} Complex one- to four-family residential property appraisal means one in which the property to be appraised, the form of ownership, or market conditions are atypical.

A bank may use either a state-certified or a state-licensed appraiser for—

noncomplex residential federally related transactions that are under \$1 million.

Other Appraiser Designations

Some states have adopted other appraiser designations that may cause confusion about whether a particular appraiser holds the appropriate designation for a given appraisal assignment. Additionally, some states use designations such as "certified residential" appraiser and "certified general" appraiser, which leads to further confusion. Other states have no specified license designation, but use the term "certified residential," based on the standards for licensing. For this reason, the bank needs to understand the qualifications criteria set forth by the state appraiser regulatory body and whether these standards are the equivalent to the federal designations as accepted by the Appraisal Subcommittee.

Currently, the Appraisal Subcommittee has recognized four state appraiser designations: certified general, certified residential, licensed, and transitional licensed. For the certified residential appraiser, the minimum qualification standards are those established by the Appraiser Qualifications Board for "certified residential real estate appraiser." Under the Board's regulation, a certified residential appraiser would be permitted to appraise real estate in connection with a federally related transaction designated for a "certified" appraiser so long as the individual is competent for the particular appraisal assignment.

The Appraisal Subcommittee and the Board have also expressed their willingness to recognize a transitional license, which would allow a state to issue a license to an appraiser provided that the individual has passed an examination and has satisfied either the education or experience requirement. A transitional-licensed appraiser is permitted to appraise real estate collateral in connection with a federally related transaction as if licensed. The transitional-licensed appraiser is expected to complete the missing education or experience requirement within a set timeframe or the license expires.

The recognition of a transitional license was believed to be necessary to ease the initial problems and inefficiencies resulting from the establishment of a new regulatory program. The Appraisal Subcommittee has advised the states that the use of the transitional license should be phased out over time once the appraiser regulatory program is fully established. As a result, the use of transitional license and the applicable timeframe will vary from state to state.

Qualifications of Individuals Who May Perform Evaluations

Evaluations may be performed by a competent person who has experience in real estate-related activities, which includes but is not limited to appraisals, real estate lending experience, real estate consulting, and real estate sales. A bank may also augment in-house expertise by hiring an outside consultant familiar with a certain market or a particular type of real estate. The bank's evaluation procedures should have established standards for selecting qualified individuals to perform evaluations and confirming their qualifications and independence to perform an evaluation for a particular transaction. An individual performing an evaluation need not be licensed or certified. However, if a bank desires, it may use state-licensed or -certified appraisers to prepare evaluations.

SUPERVISORY POLICY

A bank's appraisal and evaluation policies and procedures are reviewed as part of the examination of an institution's overall real estate—related activities. This includes a review of the procedures for selecting an individual for a particular appraisal or evaluation assignment and confirming that the individual is qualified, independent, and, if applicable, licensed/certified to undertake the assignment. If an institution maintains a list of qualified real estate appraisers acceptable for the bank's use, the examiner should ascertain whether the board of directors or senior management has reviewed and approved the list.

If a bank is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the bank to obtain appraisals for all *new* real estate—

related financial transactions below the threshold that are not subject to another exemption. The Reserve Bank will determine if a particular bank will have to obtain appraisals below the threshold.

When analyzing individual credits, examiners look at appraisals or evaluations to determine if the methods, assumptions, findings, and conclusions are reasonable and in compliance with the Board's rule, policies, and supervisory guidelines. Examiners should not challenge the underlying assumptions, including discount rates and capitalization rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. Additionally, an examiner is not bound to accept the results of the appraisal or evaluation, regardless of whether a new appraisal or evaluation was requested during the examination. If an examiner concludes that an appraisal or evaluation is deficient for any reason, that fact will be taken into account in reaching a judgment on the quality of the credit.

When the examiner can establish that the underlying facts or assumptions are inappropriate and can support alternative assumptions, the examiner may adjust the estimated value of the property for credit-analysis purposes. It is important to emphasize that an examiner's overall analysis and classification of a credit may be based upon other credit or underwriting stan-

dards, even if the loan is secured by real property whose value is supported by an appraisal or evaluation. (Further discussion on the examiner's assessment of value for loan classification is in the manual sections 2060 and 2090, "Classification of Credits" and "Real Estate Loans.")

Significant failures to meet standards and procedures as outlined above will be criticized and corrective action will be required. Furthermore, inadequate appraisal and evaluation procedures may be considered an unsafe and unsound banking practice if the failure to accurately reflect the value of assets on a timely basis misrepresents the bank's financial condition. In this situation, formal corrective measures will be pursued as appropriate.

The appraisal regulation and guidelines require that banks use the services of qualified, independent certified or licensed appraisers to perform appraisals. Furthermore, a bank that knowingly uses the services of an individual to perform an appraisal in connection with a federally related transaction who is not properly certified or licensed is in violation of section 1120(a)(1) of title XI of FIRREA. Any action of a statecertified or -licensed appraiser that is contrary to the purpose of title XI should be reported by the examiner to the Federal Reserve Bank for referral to the appropriate state appraiser regulatory agency for investigation.

Real Estate Appraisals and Evaluations Examination Objectives

Effective date November 1995

Section 4140.2

- To determine whether policies, practices, procedures and internal controls regarding real estate appraisals and evaluations for real estate—related financial transactions are adequate.
- To determine whether bank officers and employees are operating in conformance with the board of director's appraisal policies.
- To determine that appraisals performed in connection with federally related transactions comply with the minimum standards of the Board's regulation and the Uniform Standards of Professional Appraisal Practice.
- 4. To determine that appraisers used in connec-

- tion with federally related transactions are certified or licensed as appropriate.
- 5. To determine that appraisers are competent to render appraisals in federally related transactions, and are independent of the specific transaction, or other lending, investment, or collection functions as appropriate.
- To initiate corrective action when policies, practices, procedures or internal controls are deficient, or when violations of laws or regulations or noncompliance with provisions of supervisory guidelines have been noted.

Real Estate Appraisals and Evaluations

Examination Procedures

Effective date September 1992

Section 4140.3

- Based upon the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
- Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review performed by internal/external auditors and determine if appropriate corrections have been made.
 - a. Provide copies of the bank's appraisal and evaluation policies and procedures to examiners assigned to functional areas where real estate-related transactions may require the services of an appraiser or evaluator.
 - b. When individual real estate—related transactions such as loan or OREO transactions are examined, appraisals and evaluations should be reviewed for compliance with the Board's appraisal regulation, the interagency appraisal guidelines, and the bank's appraisal and evaluation programs.
 - c. When real estate—related transactions are examined on a portfolio basis, the appraisal and evaluation processes for the specific activity should be examined. Examiners should determine whether these processes ensure that appraisals and evaluations comply with the Board's appraisal regulation, the interagency appraisal guidelines, and the bank's appraisal and evaluation programs.
- 3. Regarding appraisal and evaluation programs:
 - a. Has the board of directors adopted policies and procedures that establish appraisal and evaluation programs?
 - b. Do these programs include appraisal and evaluation critique procedures?
 - c. Do the appraisal and evaluation programs establish the manner in which the institution selects, evaluates, and monitors individuals who perform or critique real estate appraisals or evaluations?
 - d. Does the appraisal program ensure that appraisals conform to the Board's appraisal regulation?
 - e. Does the evaluation program ensure that

- evaluations conform to the Board's guidance on evaluations?
- f. Do these programs reflect appropriately the bank's size, location, and the nature and complexity of the bank's real estate– related activities?
- g. Do these policies and procedures require that appraisals and evaluations be written?
- h. Does the board or senior management review annually its appraisal and evaluation related policies and procedures, and record such review in its minutes?
- 4. Evaluate the bank with respect to:
 - a. The adequacy of written appraisal and evaluation programs.
 - The manner in which bank officers are operating in conformance with established policy.
 - c. Internal control deficiencies or exceptions.
 - d. The integrity of the appraisal and evaluation process, including appraisal and evaluation compliance procedures.
 - e. The integrity of individual appraisals and evaluations regarding the adequacy, reasonableness, and appropriateness of the methods, assumptions, and techniques used, and their compliance with the Board's appraisal regulation and interagency real estate appraisal and evaluation guidelines.
 - f. The eligibility of the bank to assign a 50 percent risk weight to certain one- to four-family residential mortgage loans for risk-based capital purposes. See the section on Assessment of Capital Adequacy.
 - g. Recommended corrective action when policies, practices, or procedures are deficient
 - h. The degree of violations, if any, of the Board's appraisal regulation, and extent of noncompliance with the interagency appraisal guidelines, if noted.
 - i. Other matters of significance:
 - misrepresentation of data such as the omission of information on favorable financing, seller concessions, sales history, feasibility, zoning, easements, or deed restrictions.
 - inadequate techniques of analysis, i.e., failure to use cost, comparable sales, or income approach in the appraisal when

- the approach is appropriate for the type of property.
- use of dissimilar comparables in the comparable sales approach to valuation, e.g., age, size, quality or location of comparable is significantly different from subject property making reconciliation of value difficult.
- underestimation of factors such as construction cost, construction period, lease-up period, and rent concessions.
- use of best case assumptions for the income approach to valuation without performing a sensitivity analysis on the factors which would identify the lender's downside risk

- overly optimistic assumptions such as a high absorption rate in an overbuilt market.
- demographic factors such as existing housing inventory, projected completions, and expected market share are not reconciled to the value rendered, but are only discussed as background information.
- Report any instances of questionable conduct by appraisers along with supporting documentation to the Reserve Bank for possible referral to the appropriate state appraisal authorities.
- 6. Update workpapers with any information that will facilitate future examinations.

Real Estate Appraisals and Evaluations Internal Control Questionnaire

Effective date September 1992

Section 4140.4

Review the bank's internal controls, policies, practices and procedures for real estate appraisals and evaluations. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

- Has the board of directors, consistent with its duties and responsibilities, adopted written appraisal and evaluation policies that define:
 - a. Bank management's responsibility for selecting, evaluating and monitoring the individual who is performing the appraisal or evaluation?
 - b. Basis for selecting staff appraisers and engaging fee appraisers for a particular appraisal assignment, ensuring that the individual is independent of the transaction, possesses the requisite expertise, and holds the proper state certification or license if applicable?
 - c. Procedures for when to obtain appraisals and evaluations?
 - d. Procedures for when to obtain a reappraisal or reevaluation, including frequency and scope?
 - e. Appraisal and evaluation compliance procedures to determine that appraisals and evaluations comply with the Board's regulations, policies, and guidelines?
 - f. Appraisal and evaluation review procedures to ensure that the bank's appraisals and evaluations are consistent with the standards of Uniform Standards of Professional Appraisal Practice (USPAP) and the Board's regulation and guidelines?
- 2. Does the board of directors on an annual basis review its appraisal, evaluation, and review policies and procedures to ensure that the appraisal and evaluation policies and procedures meet the needs of the bank's real estate lending activity?

APPRAISALS

- *3. Are appraisals in writing, dated and signed?
- *4. Does the appraisal meet the minimum standards of the Board's regulation and the Uniform Standards of Professional Appraisal Practice, including:
 - a. Purpose?
 - b. Market value?
 - c. Effective date?
 - d. Marketing period?
 - e. Sales history of subject property?
 - f. Reflect the valuation using the cost, income, and comparable sales approaches?
 - g. Evaluate and correlate the three approaches into a final value estimate based on the appraiser's judgment?
 - h. Explain why an approach is inappropriate and not used in the appraisal?
 - i. Fully support the assumptions and the value rendered through adequate documentation?
- *5. Are appraisals received prior to the bank making its final credit or other credit decision (e.g., is the date the loan committee approved the credit later than the date of the appraisal)?
- *6. If the bank is depending upon an appraisal obtained for another federally regulated financial institution as support for its transaction, does the bank have appraisal review procedures to ensure that the appraisal meets the standards of the appraisal regulation? These types of transactions would include loan participations and mortgage-backed securities.
- *7. If an appraisal for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the appraisal is still valid?

APPRAISERS

- 8. Are appraisers fairly considered for assignments regardless of their membership or lack of membership in a particular appraisal organization?
- 9. Do appraisers have requisite knowledge

- and experience to complete the appraisal prior to taking the assignment?
- 10. Do appraisers that discover deficiencies in their expertise prior to taking the assignment, or while performing the appraisal:
 - a. Disclose their lack of knowledge and/or experience to the client prior to accepting the assignment, or at the point that the deficiencies became readily apparent?
 - b. Describe in the appraisal their lack of knowledge and/or experience and the steps taken to competently complete the assignment?
- 11. Are appraisers independent of the transaction?
 - a. Are staff appraisers independent of the lending, investment, and collection functions, and not involved, except as an appraiser, in the federally related transaction, and have no direct or indirect interest, financial or otherwise, in the property?
 - b. Are fee appraisers engaged directly by the bank or its agent, and have no direct or indirect interest, financial or otherwise, in the property or transaction?
- 12. If staff appraisers are used, does the bank periodically have test appraisals made by independent appraisers to check the bank's knowledge of trends, values, and markets?
- 13. If fee appraisers are used by the bank, does the bank investigate their qualifications and reputations?
- 14. Is the status of an appraiser's state certification or license verified with the state appraiser regulatory authority to ensure that the appraiser is in good standing?
- 15. Are fee appraisers paid the same fee whether or not the loan is granted?
- 16. If the transaction is outside the local geographic market of the bank, does the bank engage an appraiser with knowledge of the market where the real estate collateral is located?

EVALUATIONS

- 17. Are individuals performing evaluations independent of the transaction?
- *18. Are evaluations required to be in writing, dated, and signed?
- *19. Does the bank require sufficient information and documentation to support the estimate of value and the evaluator's analysis?
- *20. If an evaluation obtained for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the evaluation is still valid?
- *21. Are evaluations received prior to the bank entering into a binding commitment?
- *22. If the bank is depending upon an evaluation obtained for another federally regulated financial institution as support for its transaction, does the bank have evaluation review procedures to ensure that the evaluation meets the Board's regulation and guidance?

EVALUATORS

- 23. Are individuals who perform evaluations competent to complete the assignment?
- 24. Are evaluations prepared by individuals who are independent of the transaction?

REAPPRAISALS AND REEVALUATIONS

- 25. Does the bank follow a formal reappraisal and reevaluation program?
- 26. Does the bank sufficiently document and follow its criteria for obtaining reappraisals or reevaluations?

Effective date May 1996

INTRODUCTION

The Federal Reserve System relies on the timely and accurate filing of regulatory reports by domestic and foreign financial institutions. Data collected from regulatory reports facilitate early identification of problem situations that can threaten the safety and soundness of reporting institutions; ensure timely implementation of the prompt-corrective-action provisions required by banking legislation; and serve other legitimate supervisory purposes. Certain regulatory report information is used for public disclosure so investors, depositors, and creditors can better assess the financial condition of the reporting banks. Information primarily from the Consolidated Reports of Condition and Income (call report) is used to prepare the Uniform Bank Performance Report (UBPR), which employs ratio analysis to detect unusual or significant changes in a bank's financial condition as of the reporting dates. The UBPR is also used to detect changing patterns of behavior in the entire banking system; consequently, any inaccurate data in the regulatory reports may result in ratios that conceal deteriorating trends in the bank and/or the industry.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended various banking statutes to enhance the Federal Reserve's authority to assess civil money penalties against state member banks, bank holding companies, and foreign institutions that file "late," "false," or "misleading" regulatory reports. The civil money penalties can also be assessed against individuals who cause or participate in such filings.

The Federal Reserve has identified a late regulatory report as an official copy of a report that is not received by the Reserve Bank or its designated electronic collection agent in a timely manner. The filing of an institution's completed original report is timely in the following cases:

- The report is received by the end of the reporting day on the submission deadline.
- The report is mailed first class and postmarked no later than the third calendar day preceding the submission deadline, regardless of when the report is received by the Federal Reserve District. In the absence of a postmark, an

- institution may be called on to provide proof of timely mailing if the report has been received after the submission deadline.
- The completed original report is put into an overnight delivery system on the day before the submission deadline. An institution may be called on to provide proof of timely entry if the report has been received after the submission deadline.
- For electronic filers, the report is received by the Reserve Bank by the end of the reporting day on the submission deadline, or, for Consolidated Reports of Condition and Income, the report is received by the electronic collection agent by the submission deadline.

The filing of a false report generally involves the submission of mathematically incorrect data, such as addition errors or transpositions, or the submission of a regulatory report without appropriate schedules. Conversely, the filing of a misleading report involves some degree of negligent behavior on the part of the filer that results in the submission of inaccurate information to the Federal Reserve.

The Federal Reserve System has a Regulatory Reports Monitoring Program (program) to identify those banking institutions it supervises—including state member banks, bank holding companies, Edge Act and agreement corporations, and the branches and agencies of foreign banks—that file late and false reports. Each Reserve Bank identifies and maintains records of late and false reporters; however, Reserve Banks are no longer required to submit monthly exception reports to the Board.

Generally, all regulatory reports of financial condition and income that are required by statute and regulation to be filed with the Federal Reserve by domestic and foreign banking organizations are subject to the program. However, reports filed in connection with supervisory actions, applications for mergers and acquisitions, and the Confidential Report of Operations (FR 2068) filed by foreign banking organizations, as well as Federal Reserve monetary aggregate reports, are not subject to the program.

To promote consistent treatment under the program, the Reserve Banks may not grant grace periods or extensions of the submission dates of regulatory reports of more than five calendar days without first consulting the Board. No extensions of due dates greater than five calen-

dar days will be allowed, unless there are exigent circumstances. In addition, the program requires Board staff responsible for enforcement actions to consult with Reserve Bank staff to ensure that chronic late and false reporters are subject to appropriate follow-up supervisory actions.

The program is not designed to automatically assess civil money penalties or initiate any other type of enforcement action against banking institutions that the Federal Reserve supervises. However, Reserve Banks should continue to determine, on a case-by-case basis, when a banking institution has become a chronic late or false reporter and what supervisory action it will recommend against such a reporter.

REVIEW AND REFILING OF REGULATORY REPORTS

"Review of regulatory reports" involves determining whether the management of the member bank has submitted all required reports to the Federal Reserve in a timely and accurate manner. The examiner assigned to a specific area of examination is responsible for reviewing those reports relating to that area and for verifying that the reports are accurate and meet statutory and regulatory requirements. If the examiner finds a material difference in the reports, management should be instructed to refile corrected copies, if appropriate.

Examiners should discuss on the "Examination Conclusions and Comments" and "Matters Requiring Board Attention" pages of the examination report material errors or the filing of chronically late reports. They also should discuss with Reserve Bank staff any regulatory report filing that is considered misleading; such a report could lead to the issuance of criminal referrals against the involved individuals. In addition, management should be reminded that civil money penalties or other enforcement proceedings could occur as a result of chronically late or false regulatory report filers.

Banks should maintain effective manual or automated internal systems and procedures to ensure that reporting meets the appropriate regulatory requirements. They should develop clear, concise, and orderly workpapers to support the compilation of data. Preparation of proper workpapers provides not only a logical tie between report data and the bank's financial records, but also facilitates accurate reporting and verification. Ideally, as part of an effective internal control program, bank management should implement a procedure to verify the compilation of the data. At a minimum, an independent person or department should verify the data that have been compiled for inclusion in the report.

A bank's internal control and audit programs for regulatory reports should be sufficient to ensure that all required reports are submitted on time and are accurate. The specific internal controls employed by a bank to meet those objectives depend largely on the volume of reports, the scope of a bank's operations, and the complexity of its accounting system.

COMMONLY REQUIRED REGULATORY REPORTS

This section describes the regulatory reports most commonly required either to be submitted by the member bank to the Federal Reserve Bank or the Board, or to be maintained by the member bank for review during an examination.

Consolidated Reports of Condition and Income

Under 12 USC 324 and the Board's Regulation H, all state member banks are required to file Consolidated Reports of Condition and Income (call report) as of the last day of each calendar quarter. The specific reporting requirements, including the form to be used, depend on the asset size of the bank and whether it has a foreign office. Details of the appropriate reporting guidelines, along with the specific report form to be filed, are found in the "Instructions for Preparation of Reports of Condition and Income."

The bank should submit completed call reports to the appropriate supervisory agencies no more than 30 calendar days after the report date. Any bank with more than one foreign office, other than a shell branch or international banking facility, may request from its supervisory agency a 15-day extension of the submission deadline. State member banks are no longer required to publish their Report of Condition, according to section 308 of the Riegle Community Development and Regulatory Improvement Act of 1994 and the subsequent revisions to section 208.10

of Regulation H. However, a state member bank may still be required to publish its Report of Condition under state law. In addition, state member banks continue to be required, under section 208.17 of the Board's Regulation H, to advise its shareholders, customers, and the general public of the availability of year-end call reports and other financial information. There are no federal publication requirements for state member or nonmember banks' Report of Income.

The Report of Condition provides consolidated, detailed financial information on assets, liabilities, capital, and off-balance-sheet activity, which permits a uniform analysis and comparison of the reporting bank's data to that of other insured banks. The report also aggregates certain figures on loans to executive officers, directors, principal shareholders, and their related interests. The Report of Income provides information on consolidated earnings, changes in capital accounts and the allowance for loan and lease losses, and charge-offs and recoveries.

The examiner should carefully review both reports to ensure that all pertinent data have been reported and are properly categorized in accordance with the instruction manual. To understand a particular bank's call report, the examiner must understand the bank's accounting methods as well as the information located in, and the relationships between, the bank's general books and subsidiary ledgers. This understanding can be obtained only by a careful review of the workpapers used in the preparation of these reports and their supplementary schedules.

Reports of Indebtedness to Correspondent Banks

Section 215.22 of the Board's Regulation O requires principal shareholders and executive officers of member banks and such persons' "related interests" to make a written report by January 31 to the board of directors of their bank if they have outstanding an extension of credit from a correspondent bank of their own bank during the preceding year.

A correspondent bank is defined as a bank that maintains one or more correspondent accounts for a member bank during the calendar year that, when aggregated, exceed certain amounts specified in the regulation. Form FFIEC 004, or a substitute acceptable to the bank, is to

be used for reporting those transactions. These reports will facilitate the review of insider transactions by examiners, directors, senior management, auditors, and attorneys.

REPORTS REQUIRED BY THE MONETARY CONTROL ACT OF 1980

The Federal Reserve has established a basic deposits-reporting framework for administering Regulation D, Reserve Requirements of Depository Institutions, and for constructing, analyzing, and controlling the monetary and reserves aggregates. The framework consists of five reporting categories, which are defined by two measures:

- the reserve requirement "exemption amount," which is the amount of total reservable liabilities at each depository institution that is subject to a 0 percent reserve requirement, and
- two separate "deposit cutoffs" applicable to nonexempt and exempt institutions, respectively.

Both measures are indexed annually; refer to Regulation D for the appropriate exemption and cutoff amounts.

The exemption amount and the deposit cutoff for any one calendar year are used by the Federal Reserve to determine deposit-reporting panels for September of that year to September of the following year. (Annual panel determinations are discussed in the subsection below.) All deposit reports are mandatory.

Reporting Categories

In general, the larger the institution, the more detailed or frequent its reporting requirements, subject to exceptions discussed later in this section. The first two reporting categories require detailed reporting and apply to nonexempt institutions, that is, those institutions whose total reservable liabilities are greater than the reserve requirement exemption amount. The last three categories are characterized as "reduced reporting" and apply to exempt institutions, or those institutions whose total reservable liabilities are less than or equal to the exemption amount and,

therefore, are fully exempt from reserve requirements. The filing-requirement frequency of the five reporting categories is as follows:

- Nonexempt institutions with total deposits greater than or equal to the deposit cutoff for nonexempt institutions file the FR 2900 (Report of Transaction Accounts, Other Deposits and Vault Cash) weekly. The report covers a seven-day reporting period beginning on Tuesday and ending on the following Monday.
- Nonexempt institutions with total deposits less than the deposit cutoff for nonexempt institutions file the FR 2900 quarterly, in March, June, September, and December. Each quarterly report covers a seven-day reporting period starting on the third Tuesday of the given month and ending the following Monday. All nonexempt institutions with foreign branches or that obtain funds from foreign sources file the FR 2950 or FR 2951 (Report of Certain Eurocurrency Transactions) with the same frequency as the FR 2900, which is based on their deposit cutoff.
- Exempt institutions with total deposits greater than or equal to the deposit cutoff for exempt institutions file the less detailed FR 2910q (Quarterly Report of Selected Deposits, Vault Cash and Reservable Liabilities). The FR 2910q is filed quarterly, in March, June, September, and December for the seven-day period that begins on the third Tuesday of the given month and ends the following Monday.
- Exempt institutions with total deposits greater than or equal to the exemption amount but less than the deposit cutoff for exempt institutions file the two-item FR 2910a (Annual Report of Total Deposits and Total Reservable Liabilities). This report is filed as of the Monday that follows the third Tuesday each June (which corresponds to the last day of the June reporting week for quarterly FR 2900 and FR 2910q reports).
- Exempt institutions with total deposits less than the exemption amount are generally not required to submit any deposits report as long as their total deposits, or estimates thereof, can be derived by the Federal Reserve from other existing sources of data, such as call reports.

Exceptions to the above categories: Edge Act and agreement corporations and U.S. branches and agencies of foreign banks, regardless of the level of deposits or reservable liabilities they

have, must file the FR 2900 or FR 2951 (Eurocurrency report) weekly.

Allocation Report

Regulation D allows only a single exemption and a single low-reserve tranche for all combined offices of the same parent depository institution. For the calculation of required reserves, any FR 2900 respondent, whether weekly or quarterly, that files separate reports for individual offices (or groups of offices) also is required to file at least annually a report that allocates the exemption and the low-reserve tranche among those offices (FR 2930 or FR 2930a). (Currently, only about 200 institutions file the allocation report, mostly Edge and agreement corporations, U.S. branches and agencies of foreign banks, and a handful of savings and loan institutions.)

Annual Panel Determinations

Each year the Federal Reserve reviews the institutions in the five reporting categories, and reassignments of institutions ("panel shifts"), as necessary, occur each September. The panel shifts reflect movements in each individual depository institution's total deposits or total reservable liabilities across the prevailing boundaries (the exemption amount and the deposit cutoff) that separate the reporting categories. Documentation is available on the Federal Reserve's procedures (including the reports, data items, and reporting periods) for measuring an institution's total reservable liabilities and total deposits against the prevailing cutoffs for the annual panel determinations. Two special types of panel shifts are described below.

Voluntary shifts. By late summer, the Federal Reserve informs each institution of its particular reporting requirement for September of that year to September of the following year. Any depository institution assigned to one particular category may elect instead to report deposits (and, if appropriate, to maintain reserves) in accordance with a higher-level category. (For example, an institution assigned to the FR 2900 quarterly reporting category may elect instead to report the FR 2900 weekly.) However, any such volun-

tary shifts may take place only once a year during the normal September panel shifts. Voluntary shifts to a lower-level category are not permitted.

 Fast-growing institutions. The Federal Reserve may require a depository institution that is experiencing above-normal growth to report on a more detailed or frequent basis before the September panel shifts.

REPORTS REQUIRED UNDER REGULATION H AND THE SECURITIES EXCHANGE ACT OF 1934

Section 208.16(a) of Regulation H requires that state member banks whose securities are subject to registration under sections 12(b) or 12(g) of the Securities Exchange Act of 1934 (the 1934 act) to file reports with the Board that are also filed with the Securities and Exchange Commission (SEC). The specific reports required by the Board and the SEC are found in sections 12, 13, 14(a), 14(c), 14(d), 14(f), and 16 of the 1934 act. Section 208.16(b) also allows some banks with total assets of \$150 million or less to make certain elections regarding the Board's reporting requirements.

After confirming that a bank is a publicly traded company that must file reports with the SEC, the examiner should consult with the bank's management to ensure that the reports required by Regulation H are filed with the Board. Listed below are some of the common forms required pursuant to the 1934 act and Regulation H; however, since the list is not all-inclusive, the examiner should refer to the regulation and statute.

Section 12 of the 1934 Act

Form 8-A is for the registration of certain classes of securities pursuant to sections 12(b) or 12(g) of the 1934 act for, among other things, listing on national securities exchanges. Form 8-B is for the registration of securities of certain successor issuers pursuant to sections 12(b) or 12(g) of the 1934 act. Form 10 is the general form for registration of securities pursuant to sections 12(b) or 12(g) of the 1934 act for classes of securities of issuers for which no other form is prescribed.

Section 13 of the 1934 Act

Form 8-K must be filed within 15 days after the occurrence of the earliest of one or more specified events that are required to be reported and that affect the bank or its operations, such as changes in control of registrant or in acquisition or disposition of significant assets. Form 10-Q is for quarterly and transition reports and must be filed within 45 days after the end of each of the first three fiscal quarters. Form 10-K is for annual and transition reports that must be filed within 90 calendar days after the end of the registrant's fiscal year.

Section 16 of the 1934 Act

Form 3 is an initial statement of beneficial ownership of registered companies, including securities of the bank. Form 4 represents a statement of changes of beneficial ownership of registered companies, including securities of the bank. Form 5 is an annual statement of the beneficial ownership of registered companies, including the securities of the bank.

LOST AND STOLEN SECURITIES REPORTING AND INQUIRY REQUIREMENTS

Every national securities exchange member, registered securities association member, broker, dealer, municipal securities dealer, government securities broker or dealer, registered transfer agent, and registered clearing agency and its participants, as well as every member bank of the Federal Reserve System and every bank whose deposits are insured by the Federal Deposit Insurance Corporation (reporting institutions), must register with the Securities and Exchange Commission's designee, the Securities Information Center, Inc. (SIC). All lost, missing, stolen, or counterfeit securities must be reported to the SIC. Except in certain limited circumstances, each insured bank is responsible for contacting the SIC to determine if the securities coming into its possession, whether by pledge, transfer, or some other manner, have been previously reported as missing, lost, stolen, or counterfeit.

All functions within a bank that handle or process securities are subject to the reporting

requirements. Only the transfer agent function is exempt from the *inquiry* requirements. Accordingly, all bank departments likely to be affected, including the trust, investment, transfer agent, custody, or dealer departments, and the lending operations as relating to collateral loans, should be familiar with the requirements set out in 17 CFR 240.17f-1. Securities exempt from the reporting requirements are—

- registered securities of the U.S. government and federal agencies thereof,
- securities that have not been assigned CUSIP numbers, and
- bond coupons.

Securities exempt from the inquiry requirements are—

- securities received directly from the issuer or its agent at issuance,
- securities received from another reporting institution or from a Federal Reserve Bank or Branch.
- securities received from a customer of the reporting institution in the name of the customer or nominee, and
- securities that are a part of a transaction of \$10,000 or less (aggregate face value for bonds or market value for stocks).

Lost, Missing, Stolen, or Counterfeit Securities

Form X-17F-1A must be filed with the SIC within one business day after the discovery of—

- a theft or loss of any security when there is a substantial indication of criminal activity,
- a security that has been lost or missing for two business days, and
- · a security that is counterfeit.

The form must be filed within two business days of notification of nonreceipt when delivery of securities sent by the bank—

- is made by mail or via draft and payment is not received within 10 business days, and confirmation of nondelivery has been made by the receiving institution; and
- is in person and no receipt is maintained by the bank.

If securities sent by the bank, either in person or through a clearing agency, are lost in transit and the certificate numbers of the securities can be determined, the bank must supply the receiving institution with the certificate numbers of the securities within two business days from the date of the request from the receiving institution. The delivery of lost or missing securities to the bank must be reported within one business day after discovery and notification of certificate numbers. Securities that are considered lost or missing as a result of counts or verifications must be reported no later than 10 business days after discovery or as soon as certificate numbers can be ascertained.

Copies of all reports required to be filed under 17 CFR 240.17f-1 must also be submitted to the registered transfer agent for the issue being reported and, if criminal activities are suspected, to the Federal Bureau of Investigation. Copies of filed or received Forms X-17F-1A must be maintained in an easily accessible place for three years.

TRANSFER AGENT ACTIVITIES

If a bank acts as a transfer agent for its own stock, the stock of its holding company, or any other equity security, it may have to register with the Board of Governors as a transfer agent pursuant to the requirements of Regulation H (section 208.8(f)) by filing uniform interagency Form TA-1. A discussion of the bank's responsibilities as a transfer agent, the reports and filing requirements, and other information, including examination procedures, are discussed in the Board's *Transfer Agent Examination Manual*. The Board has also developed a separate Report of Examination of Transfer Agents. (See "Other Types of Examinations," section 6010.1, of this manual.)

MUNICIPAL SECURITIES DEALER ACTIVITIES

A state member bank, subsidiary, department, or division thereof that is a municipal securities dealer must register with both the SEC and the Board as a municipal securities dealer by filing Form MSD, pursuant to SEC Rule 15Ba2-1. A discussion of the bank's responsibilities as a municipal securities dealer, filing requirements, and other information, including examination

procedures, are discussed in the Board's *Municipal Securities Dealer Examination Manual*. The Board has also developed a separate Report of Examination of Municipal Securities Dealer Activities.

GOVERNMENT SECURITIES BROKER AND DEALER ACTIVITIES

If a state member bank, a foreign bank, a state branch or agency of a foreign bank, or a commercial lending company owned or controlled by a foreign bank acts as a government securities broker and/or dealer, it may have to file notice with the Board as a government securities broker and/or dealer by filing Form FR G-FIN, pursuant to section 15C(a)(1)(B) of the Securities Exchange Act of 1934. A discussion of the bank's responsibilities as a government securities broker and/or dealer, filing requirements, and other information, including examination procedures, are discussed in the Board's supervisory letter SR-87-37. The Board has developed a separate Summary Report of Examination of Government Securities Broker/ Dealer or Custodial Activities.

INTERNATIONAL ACTIVITIES

A bank must file certain reports if it is conducting or intends to conduct international activities through either foreign branches or Edge Act or agreement corporations. Listed below is a brief description of each of these reports.

FFIEC 009—Country Exposure Report

This report is filed quarterly by all U.S. banks and bank holding companies that meet certain ownership criteria and that, on a fully consolidated basis, have total outstanding claims on foreign residents in excess of U.S. \$30 million (or equivalent). Information is collected on the distribution by country of these foreign claims held by U.S. banking organizations.

FFIEC 009a—Country Exposure Information Report

This report is a quarterly supplement to the

Country Exposure Report (FFIEC 009) that provides public disclosure of significant country exposures of U.S. banking institutions. Part A must be filed when exposure to a single country exceeds 1 percent of the banking institution's total assets or 20 percent of that institution's primary capital, whichever is less. Part B provides a list of countries where exposure exceeds 0.75 percent of the respondent's assets or 15 percent of primary capital, whichever is less.

FFIEC 030—Foreign Branch Report of Condition

Every insured commercial bank with one or more branch office in a foreign country is required to file this report as of December 31 of each year. Significant branches, with either total assets of at least \$2 billion or commitments to purchase foreign currencies and U.S. dollar exchange of at least \$5 billion as of the end of a quarter, are required to file the report quarterly.

FFIEC 035—Monthly Consolidated Foreign Currency Report of Banks in the United States

U.S. banks and banking institutions, including bank holding companies, are required to provide, on a fully consolidated basis, monthly data on their gross assets, gross liabilities, and positions in foreign currencies. This report is filed by institutions that have greater than \$1 billion in commitments to purchase foreign currencies and U.S. dollar exchange as reported in Schedule RC-L of the call report, filed as of the most recent third quarter of each year.

FR 2058—Notification of Foreign Branch Status

This report should be filed by any member bank, bank holding company, or Edge Act or agreement corporation within 30 days of the opening, closing, or relocation of a foreign branch of that U.S. organization or of its foreign subsidiary(ies).

FR 2064—Report of Changes in Investments Made under Regulation K, Subparts A and C

This report is required to be filed no later than the last day of the month following the month in which the acquisition or disposition of a reportable investment governed by Regulation K occurred.

FR 2314—Annual Report of Condition for Foreign Subsidiaries of U.S. Banking Organizations

- FR 2314a—This report should be filed as of December 31 of each year by foreign companies with total assets exceeding U.S. \$100 million
- FR 2314b—This report should be filed as of December 31 of each year by foreign companies with total assets greater than or equal to \$50 million and less than or equal to \$100 million
- FR 2314c—This report should be filed as of December 31 of each year by foreign companies with total assets less than \$50 million.

FR 2502q—Quarterly Report of Assets and Liabilities of Large Foreign Offices of U.S. Branches

This report is collected from large foreign branches of U.S. banking institutions, Edge Act and agreement corporations, and large foreign bank subsidiaries. It provides a geographic breakdown of each office's assets and liabilities. Branches of a U.S. bank with \$150 million or more in total assets and foreign banking subsidiaries with \$2 billion or more in total assets, or \$10 million in deposit liabilities, are required to file this report.

FR 2886b—Report of Condition and Income for Edge Act and Agreement Corporations

This report covers the operations of the reporting corporation, including any international banking facilities of the reporter. At a minimum, corporations engaged in banking must submit this report quarterly.

FR 2915—Report of Foreign Currency Deposits

This report collects seven-day averages of the amounts outstanding of foreign currency—denominated deposits held at U.S. offices of the depository institution, converted to U.S. dollars and included in the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900). The report is collected with the reporting week that begins the third Tuesday of March, June, September, and December.

Treasury International Capital Forms

The following reports are collected to gather information on international capital movements by U.S. banks and their Edge Act and agreement corporations, other depository institutions, international banking facilities, and bank holding companies. A \$15 million (or equivalent) threshold applies to reporting institutions.

- BL-1 Liabilities to Foreigners, Payable in Dollars
- BL-2 Custody Liabilities to Foreigners
- BL-3 Intermediary's Notification of U.S. Nonbank Borrowing from Foreigners, Payable in Dollars
- BC Claims on Foreigners, Payable in Dollars
- BQ-1 Part 1. Claims on Foreigners
 - Part 2. Domestic Customers' Claims on Foreigners Held by Reporter
- BQ-2 Part 1. Liabilities to and Claims on Foreigners Payable in Foreign Currencies
 - Part 2. Domestic Customers' Claims on Foreigners (in foreign currencies)
- S Purchase & Sales of Long-Term Securities by Foreigners

Treasury Foreign Currency Report

Weekly reports are required of U.S. banking organizations (Form FC-1) or their majority-owned foreign subsidiaries (Form FC-2) with net foreign currency positions of U.S. \$100 million (or equivalent) or more for specified currencies.

Review of Regulatory Reports Examination Objectives

Effective date May 1996

Section 4150.2

- 1. To determine that required reports are being filed on time.
- 2. To determine that the contents of reports are accurate.
- 3. To effect corrective action when official reporting, practices, policies, or procedures are deficient.

Review of Regulatory Reports Examination Procedures

Effective date May 1993

Section 4150.3

- Complete or update the Internal Control Questionnaire, if selected for implementation.
- Determine the bank's historical record of submitting timely and accurate reports by reviewing workpapers and the Regulatory Reports Monitoring Program.
- 3. Instruct those examiners assigned specific departments that generate regulatory reports to:
 - a. Determine from department records what regulatory reports should have been filed because of the passage of time or the occurrence of an event.
 - Obtain copies of all regulatory reports filed by the department since the previous examination.
 - c. Check the reports obtained in the preceding step and the date of filing against statutory and regulatory requirements.
 - d. Instruct the bank to prepare and submit any delinquent reports.
 - e. For the most recent filing of those reports submitted on a periodic basis and all other reports submitted since the last examination, perform the following:
 - Reconcile the line items shown on the reports to the bank's general ledger, subsidiary ledgers, or daily statements.
 - Obtain the bank's workpapers applicable to each line item and reconcile individual items to the reports.
 - Determine whether other examining personnel uncovered any misstatement of assets, liabilities, income, or expense during their examination of the various departments.
 - Determine that the reports are prepared in accordance with Federal Reserve and/or other applicable instructions.
 - f. On the basis of the work performed in the preceding step, perform either of the following, as appropriate:
 - If the reports are found to be substantially correct, limit the review of the remaining periodic reports filed since the last examination to the reconciliation of financial statement account categories to general ledger control accounts.
 - · If the reports are found to be substan-

- tially incorrect, extend the procedures outlined in step 3.e to the remaining periodic reports filed since the last examination for those areas where items were found to be substantially incorrect.
- g. Scan all periodic reports for unusual fluctuations. Investigate fluctuations, if any.
- Review compliance with the missing, lost, counterfeit, or stolen securities requirements of 17 CFR 240.17f-1 by:
 - Discussing with appropriate officers and personnel the procedures in effect regarding the filing of Form X-17F-1A (Missing, Lost, Stolen, or Counterfeit Securities Report).
 - Discussing with the appropriate persons the procedures in effect regarding compliance with the inquiry requirements.
 - c. Substantiating Internal Control questions 6 through 15, as appropriate.
- 5. Prepare comments in appropriate report form and discuss with management:
 - a. Violations of law or regulations.
 - b. Inaccurate reports, and, if applicable, the need for amended reports. If amended reports are considered appropriate, consult with Reserve Bank supervisory personnel before requesting the bank to refile the report(s).
 - c. Material differences in the annual report of the state member bank whose securities are subject to registration pursuant to the Securities Exchange Act of 1934. (State law governs the furnishing of annual reports to stockholders for banks with less than 500 shareholders.)
 - d. Recommended corrective action when policies, practices, or procedures are deficient or when reports have been filed incorrectly, late, or not at all.

The comments must include, if applicable, the name(s) and the "as of" date(s) of amended report(s); and the date of filing, amount of, and explanation of any material difference existing in either the numerical items or narrative statements in the annual report.

6. Update the workpapers with any information that will facilitate future examinations.

Review of Regulatory Reports Internal Control Questionnaire

Effective date May 1993

Section 4150.4

Review the bank's internal controls, policies, practices, and procedures for regulatory reports. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow-charts, copies of forms used, and other pertinent information.

- 1. Do requests for all regulatory reports come to one individual or department?
- 2. Does that individual or department have the authority to request that required information be prepared by the applicable banking department?
- 3. To ensure that all regulatory reports are submitted on a timely basis and are accurate, determine the following:
 - a. If completion of the report requires information from several departments:
 - Is a written memorandum sent to the various departments requesting the information?
 - Is the memorandum addressed to a department head?
 - Does the memorandum have a due date?
 - Are procedures in effect to send second requests if the memorandum is not returned by its original due date?
 - Does completion of the memorandum require two signatures, that of the person gathering the information and that of the person's superior who is held responsible for its accuracy?
 - b. If completion of the report requires information from one department, is there separation of duties to ensure that the raw data to complete the report is compiled by one person and verified by another person, prior to submission?
- 4. After the report is prepared, but prior to its submission, is it checked by:
 - a. The supervisor of the department preparing the report, who takes personal responsibility for its accuracy and submission on a timely basis?
 - b. Bank personnel who have no part in the report's preparation?
- 5. Do report workpapers leave a clear audit trail from the raw data to the finished

report and are they readily available for inspection?

Review the bank's system for compliance with the reporting and inquiry requirements of the lost and stolen securities provisions of 17 CFR 240.17f-1.

- 6. Has the bank registered as a direct or indirect inquirer with the Securities Information Center, Inc.?
- 7. Are reports submitted within one business day of discovery when:
 - a. Theft or loss of a security is believed to have occurred through criminal activity?
 - b. A security has been missing or lost for two business days, except in certain cases?
 - c. A security is counterfeit?
- 8. Are reports submitted by the bank, as a delivering institution, within two business days of notification of nonreceipt when:
 - a. Delivery is in person and no receipt is maintained by the bank?
 - b. Delivery of securities is made by mail or via draft, and payment is not received within 10 business days and confirmation of nondelivery has been made by the receiving institution?
 - c. Securities are lost in transit and the certificate number(s) can be determined?
- Are reports submitted by the bank, as a receiving institution, within one business day of discovery and notification of the certificate number(s) when:
 - a. Securities are delivered through a clearing agency and the delivering institution has supplied the certificate numbers within the required two business days after request?
 - b. Securities are delivered over the window and the delivering institution has a receipt and supplies the certificate number(s) within the required two business days after request?
- 10. Are securities that are considered to be lost or missing as a result of counts or verifications reported no later than ten business days after discovery or as soon after as the certificate number(s) can be ascertained?
- Are copies of those reports submitted to the registered transfer agent for the issue and, in

- the case of suspected criminal activity, the Federal Bureau of Investigation?
- 12. Are all recoveries of securities reported within one business day of recovery or finding? (Note: Only the institution that initially reported the security as missing can make a recovery report.)
- 13. Are inquiries made when the bank takes in any security that is not:
 - a. Received directly from the issuer or issuing agent at issuance?
 - b. Received from another reporting institution or Federal Reserve bank in its capacity as fiscal agent?
 - c. Received from a bank customer and is registered in the name of the customer or its nominee?
- 14. Are all reports made on Form X-17F-1A or facsimile?

15. Are copies of Form X-17F-1A and subsequent confirmations and other information received maintained for three years in an easily accessible location?

CONCLUSION

- 16. Does the foregoing information provide an adequate basis for evaluating internal controls in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- 17. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

Effective date May 1996

Section 4160.1

INTRODUCTION

State member banks have, at times, engaged in issuing nondeposit debt securities on their own behalf or assisted in the sale of these instruments (for example, commercial paper or other shortterm or long-term debt securities, such as thrift notes and subordinated debentures) on behalf of their parent bank holding companies or other affiliates. It is important to ensure that these securities are not issued, marketed, or sold in a manner that could give the purchaser the impression that the obligations are federally insured deposits. Consequently, state member banks and their subsidiaries that have issued or plan to issue nondeposit debt securities should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank.

PROCEDURES

This policy is not intended to prevent banks from selling their uninsured debt instruments in a manner that is consistent with sound and prudent banking practices. These instruments generally may be sold to investors in various ways away from the retail deposit-taking and general lobby areas of the bank. In this regard, personnel not regularly involved in deposittaking activities or in opening new deposit accounts may make prospective investors in the community aware of uninsured debt obligations outside of the retail deposit-taking and general lobby areas. Also, these instruments may generally be sold by an employee or officer segregated from the retail deposit-taking and general lobby areas of the bank, even if the employee or officer occasionally accepts deposits or opens an account (but not as a part of his or her regular duties), so long as the arrangement is not structured in a way that misleads the purchaser or is otherwise contrary to supervisory guidelines.

Further, state member banks involved in this activity should establish procedures to ensure

that potential purchasers understand that the debt security is not federally insured or guaranteed. Specifically, the debt security should boldly state on its face that it is not insured by the Federal Deposit Insurance Corporation. In addition, this information should be verbally stated to the purchaser, and, in cases where purchasers do not take physical possession of the obligation, the purchaser should be provided with printed advice that conveys this information.

SUPERVISORY GUIDANCE

As noted, a state member bank may also become involved in the sale of uninsured debt obligations of its parent bank holding company or a nonbank affiliate. It is a longstanding policy of the Federal Reserve that debt obligations of a bank holding company or a nonbank affiliate not be issued, marketed, or sold in a way that conveys the misimpression or misunderstanding that these instruments are either (1) federally insured deposits or (2) obligations of or guaranteed by the subsidiary bank. The purchase of these holding company obligations by retail depositors of the subsidiary bank can, in the event of default, result in losses to individuals who believed that they had acquired federally insured or guaranteed instruments. In addition to the problems created for these individuals, this situation could impair public confidence in the bank and lead to unexpected withdrawals or liquidity pressures.

If a state member bank intends to market or sell or to allow its parent holding company or a nonbank affiliate to market or sell uninsured nondeposit debt obligations on bank premises, the bank should establish internal controls to ensure that the promotion, sale, and subsequent customer relationship resulting from the sale of these debt obligations is separated from the retail deposit-taking functions of the bank. For further information on commercial paper, see section 2030, "Bank Dealer Activities."

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

Examination Objectives

Effective date May 1996

Section 4160.2

- To determine if uninsured nondeposit debt obligations of the state member bank or an affiliate are sold on bank premises.
- To determine if the policies, practices, procedures, and internal controls for the sale of uninsured nondeposit debt instruments are adequate.
- To ensure that the marketing and sale of uninsured nondeposit debt instruments are not conducted in a manner that conveys the impression or suggestion that they are federally insured deposits. Additionally, holding company or affiliate instruments should
- not convey the impression or suggestion that they are obligations of or guaranteed by the state member bank.
- 4. To ensure that the marketing and sale of uninsured nondeposit debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit-taking function.
- To initiate corrective action if policies, practices, or procedures related to the sale of uninsured nondeposit debt instruments are deficient.

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

Examination Procedures

Effective date September 1992

Section 4160.3

- Verify that the bank does not sell uninsured nondeposit debt instruments at teller windows or other areas where retail deposits are routinely accepted, including general lobby areas surrounding teller windows and personal banking desks.
- Assess the adequacy of disclosures and the separation of the marketing and sale of uninsured nondeposit debt obligations from the retail deposit-taking function by assuring that:
 - a. the debt instrument, advertising, and all related documents disclose prominently in bold print that the debt instrument is not insured by the Federal Deposit Insurance Corporation (bank holding company debt instruments should also state that the instrument is not an obligation of, or guaranteed by, the bank);
 - advertisements that promote uninsured debt obligations of the bank (or an affiliate) do not also promote insured deposits of the bank in a way that could lead to confusion;
 - c. the obligor of the uninsured debt instrument is prominently disclosed and names or logos of the bank are not used on holding company or nonbank affiliate

- instruments in a way that might suggest the insured bank is the obligor;
- d. adequate verbal disclosures are made during telemarketing contacts and at the time of sale (a review of employee instructions or a telemarketing script, or appropriate questions directed to an employee handling this function, could assist an examiner in assessing the adequacy of verbal disclosure);
- e. retail deposit-taking employees of the insured depository institution are not engaged in the promotion or sale of uninsured nondeposit debt instruments;
- f. information on uninsured nondeposit debt instruments is not contained in the retail deposit statements of customers or in the immediate retail deposit-taking area; and
- g. account information on holdings of uninsured nondeposit debt instruments is not included on insured deposit statements.
- Encourage the bank to obtain a signed statement from the customer indicating that the customer understands that the uninsured debt instrument is not a deposit and is not FDIC insured.

Effective date May 1996

INTRODUCTION

Depository institutions have become increasingly involved in selling uninsured nondeposit investment products, such as mutual funds or annuities, on their premises to retail customers. In response to this development, an interagency statement on retail sales of nondeposit investment products (interagency statement) was issued on February 15, 1994, to enhance customer protection and lessen possible customer confusion that these products are insured deposits.1 The interagency statement applies to all insured banks and thrifts, including state member banks and the U.S. branches and agencies of foreign banks.

The guidelines contained in the interagency statement apply to retail recommendations or sales of nondeposit investment products made by-

- employees of a depository institution,
- · employees of an affiliated or unaffiliated third party occurring on the premises of the banking organization (including telephone sales, investment recommendations by employees, and sales or recommendations initiated by mail from its premises), and
- · sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

Retail sales include (but are not limited to) sales to individuals by depository-institution personnel or third-party personnel conducted in or adjacent to a depository institution's lobby area. The sales of government and municipal securities made in a depository institution's dealer department located away from the lobby area are not subject to the interagency statement. In addition, the interagency statement generally does not apply to fiduciary accounts administered by a depository institution. However, for fiduciary accounts where the customer directs investments, such as self-directed individual retirement accounts, the disclosures prescribed by the interagency statement (see the "Disclosures and Advertising" subsection below) should be provided. Furthermore, the interagency statement applies to affiliated brokerdealers when the sales occur on the premises of the depository institution. The interagency statement also applies to sales activities of an affiliated broker-dealer resulting from a referral of retail customers by the depository institution.

The Rules of Fair Practice of the National Association of Securities Dealers (NASD) govern sales of securities by its member brokerdealers. In addition, the federal securities laws prohibit materially misleading or inaccurate representations in connection with the offer or sale of securities and require that sales of registered securities be accompanied by a prospectus that complies with SEC disclosure requirements.

Examiners should determine whether the institution has adequate policies and procedures to govern the conduct of the sales activities on bank premises and, in particular, whether sales of nondeposit investment products are distinguished from the deposit-taking activities of the bank through disclosure and physical means that are designed to prevent customer confusion.

Although the interagency statement does not apply to sales of nondeposit investment products to nonretail customers, such as fiduciary customers, examiners should also apply the examination procedures prescribed in SR-94-34 ("Examination Procedures for Retail Sales of Nondeposit Investment Products," May 26, 1994) when retail customers are directed to the institution's trust department, where they may purchase nondeposit investment products by simply completing a customer agreement.

For additional information on the subject of retail sales of nondeposit investment products, examiners and other interested parties may find it helpful to refer to "Retail Investment Sales-Guidelines for Banks," (industry guidelines) February 1994, published collectively by six bank trade associations and available from the American Bankers Association.

^{1.} The interagency statement was issued to Federal Reserve Banks under cover of a supervisory letter, SR-94-11 ("Interagency Statement on Retail Sales of Nondeposit Investment Products," February 17, 1994). This SR-letter superseded SR-93-35 dated June 17, 1993, which addressed the retail sale of mutual funds on state member bank premises. Additional guidance regarding the interagency statement was provided in SR-95-46 ("Interpretation of Interagency Statement on Retail Sales of Nondeposit Investment Products," September 14,

PROGRAM MANAGEMENT

Banks must adopt policies and procedures governing nondeposit investment product retail sales programs. These policies and procedures should be in place before the commencement of the retail sale of nondeposit investment products on bank premises.

The bank's board of directors is responsible for ensuring that retail sales of nondeposit investment products comply with the interagency statement and with all applicable state and federal laws and regulations. Therefore, the board, or a designated committee of the board, should adopt written policies that address the risks and management of these sales programs. Policies and procedures should reflect the size, complexity, and volume of the institution's activities or, when applicable, the institution's arrangements with any third parties selling these products on bank premises. The bank's policies and procedures should be reviewed periodically by the board of directors, or its designated committee, to ensure that they are consistent with the institution's current practices, applicable laws, regulations, and guidelines.

As discussed in more detail below, a bank's policies and procedures for nondeposit investment products should, at a minimum, address disclosure and advertising, the physical separation of investment sales from deposit-taking activities, compliance and audit requirements, suitability concerns, and other sales practices and related risks. In addition, policies and procedures should address the following areas.

Types of Products Sold

When evaluating nondeposit investment products, management should consider what products best meet the needs of the bank's customers. Policies should outline the criteria and procedures that will be used to select and periodically review nondeposit investment products that are recommended or sold on the bank's premises. Institutions should periodically review the products offered to ensure they meet their customers' needs.

Use of Identical or Similar Names

Because of the possibility of customer confu-

sion, a nondeposit investment product must not have a name that is identical to the name of the bank or its affiliates. However, a bank may sell a nondeposit investment product with a similar name as long as the sales program addresses the even greater risk that customers may regard the product as an insured deposit or other obligation of the bank. Moreover, the bank should review the issuer's disclosure documents for compliance with SEC requirements, which call for a thorough explanation of the relationship between the bank and the mutual fund.

The Federal Reserve applies a stricter rule under Regulation Y (12 CFR 225.125) when a bank holding company (as opposed to a bank) or nonbank subsidiary acts as an investment advisor to a mutual fund. In this case, the fund may not have a name that is identical to, similar to, or a variation of the name of the bank holding company.

Permissible Use of Customer Information

Banks should adopt policies and procedures on the use of confidential customer information for any purpose in connection with the sale of nondeposit investment products. The industry guidelines permit institutions to share with third parties only limited customer information, such as the name, address, telephone number, and types of products owned. The guidelines do not permit the sharing of more confidential information, such as specific or aggregate dollar amounts of investments or net worth, without the customer's prior acknowledgment and written consent.

Arrangements with Third Parties

A majority of all nondeposit investment products sold on bank premises are sold by representatives of third parties. Under these arrangements, the third party has access to the institution's customers, and the bank is able to make nondeposit investment products available to interested customers without having to commit the resources and personnel necessary to sell the products directly. Third parties include wholly owned subsidiaries of a bank, bank-

affiliated broker-dealers (section 20 companies² or discount brokerage firms), unaffiliated broker-dealers, insurance companies, or other companies in the business of distributing nondeposit investment products on a retail basis.

Bank management should conduct a comprehensive review of an unaffiliated third party before entering into any arrangement. The review should include an assessment of the third party's financial status, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including its compliance with the interagency statement.

Banks should enter into written agreements with any affiliated and unaffiliated third parties that sell nondeposit investment products on bank premises. These agreements should be approved by the bank's board of directors or its designated committee. Agreements should outline the duties and responsibilities of each party; describe third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information for investment sales activities; and define the terms for use of the bank's office space, equipment, and personnel. If an arrangement includes dual employees (bank employees also utilized by a third party), the agreement must provide for written employment contracts that specify the duties of these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the interagency statement. The agreement should authorize the institution to monitor the third party's compliance with its agreement, as well as authorize the bank and Federal Reserve examination staff to have access to third-party records considered necessary to evaluate this compliance. These records should include examination results, sales practice reviews, and related correspondence provided to the third party by securities regulatory authorities. Finally, the agreement should provide for indemnification of the institution by an unaffiliated third party for the conduct of its employees in connection with its sales activities. Notwithstanding the provisions of a third-party agreement, bank management should monitor the conduct of nondeposit investment product sales programs to ensure that sales of the products are distinct from other bank activities and are not conducted in a manner that could confuse customers about the lack of insurance coverage for these investments.

Contingency Planning

Nondeposit investment products are subject to price fluctuations caused by changes in interest rates and stock market valuations. In the event of a sudden, sharp drop in the market value of nondeposit investment products, institutions may experience a heavy volume of customer inquiries, complaints, and redemptions. Therefore, management should develop contingency plans to address these situations. A major element of any contingency plan should be to provide customers with access to information about their investments. Other factors to consider in contingency planning include public relations and the ability of operations staff to handle increased volumes of transactions.

DISCLOSURES AND ADVERTISING

Content, Form, and Timing of Disclosures

Nondeposit investment product sales programs should ensure that customers are clearly and fully informed of the nature and risks associated with these products. In addition, nondeposit investment products must be clearly differentiated from insured deposits. The interagency statement identifies the following minimum disclosures that must be made to customers when providing investment advice, making investment recommendations, or effecting nondeposit investment product transactions:

- They are not insured by the FDIC.
- They are not deposits or other obligations of the institution and are not guaranteed by the institution.
- They are subject to investment risks, including the possible loss of the principal invested.

A nonbank subsidiary of a bank holding company that has been authorized to underwrite and deal in certain debt and equity securities that cannot be underwritten or dealt in by member banks directly.

There are limited situations in which the disclosure guidelines need not apply or where a shorter logo format may be used in lieu of the longer written disclosures.

The interagency statement disclosures do not need to be provided in the following situations:

- · radio broadcasts of 30 seconds or less;
- electronic signs,3 and
- signs, such as banners and posters, when they are used only as location indicators.

Additionally, third-party vendors not affiliated with the depository institution need not make the interagency statement disclosures on non-deposit investment product confirmations and in account statements that may incidentally, with a valid business purpose, contain the name of the depository institution.

Shorter, logo-format disclosures may be used in visual media, such as television broadcasts, ATM screens, billboards, signs, posters, and written advertisements and promotional materials, such as brochures. The text of an acceptable logo-format disclosure would include the following statements:

- · Not FDIC-Insured.
- · No Bank Guarantee.
- · May Lose Value.

Disclosure is the most important way of ensuring that the differences between non-deposit investment products and insured deposits are understood by retail customers. Accordingly, it is critical that the minimum disclosures be presented clearly and concisely in both oral and written communications. In this regard, the minimum disclosures should be provided—

- orally during any sales presentations (including telemarketing contacts) or when investment advice is given,
- orally and in writing before or at the time an investment account to purchase these products is opened, and
- in all advertisements and other promotional materials (discussed further below).

The minimum disclosures may be made on a customer account agreement or on a separate disclosure form. The disclosures must be conspicuous (highlighted through bolding, boxes, and/or a larger typeface). Disclosures contained directly on a customer account agreement should be located on the front of the agreement or adjacent to the customer signature block.

Banks are to obtain a written acknowledgment—on the customer account agreement or on a separate form—from a customer confirming that he or she has received and understands the minimum disclosures. For nondeposit investment product accounts established before the issuance of the interagency statement, banks should obtain a disclosure acknowledgment from the customer at the time of the customer's next purchase transaction. If an institution solicits customers by telephone or mail, it should ensure that the customers receive the written disclosures and an acknowledgment to be signed and returned to the institution.

Customer account statements, including combined statements for linked accounts and trade confirmations that are provided by the bank or an affiliate, should contain the minimum disclosures if they display the name or logo of the bank or its affiliate. Statements that provide account information about insured deposits and nondeposit investment products should clearly segregate the information about nondeposit investment products from the information about deposits to avoid customer confusion.

Advertising

The interagency statement provides that advertisements in all media forms that identify specific investment products must conspicuously include the minimum disclosures and must not suggest or convey any inaccurate or misleading impressions about the nature of a nondeposit investment product. Promotional material that contains information about both FDIC-insured products and nondeposit investment products should clearly segregate the information about the two product types. When promotional sales materials related to nondeposit investment products are displayed in the bank's retail areas, they should be grouped separately from material related to insured bank products.

Telemarketing scripts should be reviewed to determine whether bank personnel are inquiring

[&]quot;Electronic signs" may include billboard-type signs that are electronic, time-and-temperature signs, and ticker-tape signs. Electronic signs would not include such media as television, on-line services, or ATMs.

about customer investment objectives, offering investment advice, or identifying particular investment products or types of products. In these cases, the scripts must contain the minimum disclosures, and bank personnel relying on the scripts must be formally authorized to sell nondeposit investment products by their employers. Further, these personnel must have training that is the substantive equivalent of that required for personnel qualified to sell securities as registered representatives (see the "Training" subsection below).

Additional Disclosures

A bank should apprise customers of certain material relationships. For example, a customer should be informed by sales personnel orally and in writing before the sale about any advisory relationship existing between the bank (or an affiliate) and a mutual fund whose shares are being sold by the institution. Similarly, fees, penalties, or surrender charges associated with a nondeposit investment product should be disclosed by sales personnel orally and in writing before or at the time the customer purchases the product. The SEC requires written disclosure of this information in the investment product's prospectus.

If sales activities include any written or oral representations concerning insurance coverage by any entity other than the FDIC (for example, SIPC insurance of broker-dealer accounts, a state insurance fund, or a private insurance company), then clear and accurate explanations of the coverage must also be provided to customers at that time to minimize possible confusion with FDIC insurance. These disclosures should not suggest that other forms of insurance are the substantive equivalent to FDIC deposit insurance.

SETTING AND CIRCUMSTANCES

Physical Separation from Deposit Activities

Selling or recommending nondeposit investment products on bank premises may give the impression that the products are FDIC-insured or are obligations of the bank. To minimize customer confusion with deposit products, nondeposit investment product sales activities should be conducted in a location that is physically distinct from the areas where retail deposits are taken. Bank employees located at teller windows may not provide investment advice, recommend investment products, or accept orders (even unsolicited orders) for nondeposit investment products.

To decide whether nondeposit investment product sales activities are sufficiently separate from deposit activities, the particular circumstances of each bank need to be evaluated. FDIC insurance signs and insured deposit-related promotional material should be removed from the investment product sales area and replaced with appropriate signs indicating that the area is used for the sale of investment products. Signs referring to specific investments should prominently contain the minimum disclosures. In the limited situation where physical constraints prevent nondeposit investment product sales activities from being conducted in a distinct and separate area, the institution has a heightened responsibility to ensure that appropriate measures are taken to minimize customer confusion.

In the case of banks that are affiliated with section 20 companies that sell retail investment products directly to bank customers, the requirement for separation of deposit-taking facilities from the securities operations of the section 20 company is absolute under the relevant firewall conditions imposed on these companies by the Board. Accordingly, retail sales activities conducted by a section 20 company must be in a separate office which, at a minimum, is set off from deposit-taking activities by partitions and identified by signs with the name of the section 20 company. Further, section 20 company employees may not be dual employees of the bank. Business cards for designated sales personnel should clearly indicate that they sell nondeposit investment products or, if applicable, are employed by a broker-dealer.

The interagency statement was intended generally to cover sales made to retail customers in the bank lobby. However, some institutions may have an arrangement whereby retail customers purchase nondeposit investment products at a location of the institution that is generally confined to institutional services (for example, corporate money desk). In these cases, the bank should still ensure that retail customers receive the minimum disclosures to minimize any possible customer confusion with nondeposit investment products and insured deposits.

Hybrid Instruments and Accounts

When an institution offers accounts that link traditional bank deposits with nondeposit investment products, such as a cash-management account,⁴ the accounts should be opened in the investment sales area by trained personnel. In light of the hybrid characteristics of these products, the opportunity for customer confusion is amplified, and the institution should take special care during the account-opening process to ensure that a customer is accurately informed that

- funds deposited into a sweep account will only be FDIC-insured until they are swept into a nondeposit investment product account and
- customer account statements may disclose balances for both insured and nondeposit product accounts.

DESIGNATION, TRAINING, AND SUPERVISION OF PERSONNEL

Hiring and Training of Sales Personnel

Banks hiring sales personnel for nondeposit investment product programs should investigate the backgrounds of prospective employees. When a candidate for employment has previous investment industry experience, the bank should check whether the individual has been the subject of any disciplinary actions by securities, state, or other regulators.

Unregistered bank sales personnel should receive training that is the substantive equivalent of that provided to personnel qualified to sell securities as registered representatives. Training should cover the areas of product knowledge, trading practices, regulatory requirements and restrictions, and customer-protection issues. In addition, training programs should cover the bank's policies and procedures for sales of nondeposit investment products and should be conducted continually to ensure that staff are familiar with new products and compliance issues.

For those bank employees whose sales activities are limited to mutual funds or variable

 A hybrid account may incorporate deposit and brokerage services, credit/debit card features, and automated sweep arrangements. annuities, the equivalent training is that ordinarily needed to pass NASD's series 6 limited representative examination, which typically involves approximately 30 to 60 hours of preparation, including about 20 hours of classroom training. Bank employees who are authorized to sell additional investment products and securities should receive training that is appropriate to pass the NYSE's series 7 general securities representative examination, which typically involves 160 to 250 hours of study, including at least 40 hours of classroom training.

The training of third-party or dual employees is the responsibility of the third party. When entering into an agreement with a third party, bank management should be satisfied that the third party is able to train third-party and dual employees with respect to compliance with the minimum disclosures and other requirements of the interagency statement. Copies of third-party training and compliance materials should be obtained and reviewed by the bank to monitor the third party's performance regarding its training obligations.

Training of Bank Personnel Who Make Referrals

Bank employees, such as tellers and platform personnel, who are not authorized to provide investment advice, make investment recommendations, or sell nondeposit investment products, but who may refer customers to authorized nondeposit investment products sales personnel, should receive training about the strict limitations on their activities. In general, bank personnel who are not authorized to sell nondeposit investment products are not permitted to discuss general or specific investment products, prequalify prospective customers as to financial status and investment history and objectives, open new accounts, or take orders on a solicited or unsolicited basis. These personnel may contact customers for the purposes of-

- determining whether the customer wishes to receive investment information
- inquiring whether the customer wishes to discuss investments with an authorized sales representative, and
- arranging appointments to meet with authorized bank sales personnel or third-party broker-dealer registered sales personnel.

The minimum disclosure guidelines do not apply to referrals made by personnel not authorized to sell nondeposit investment products if the referral does not provide investment advice, identify specific investment products, or make investment recommendations.

Supervision of Personnel

Bank policies and procedures should designate, by title or name, the individuals responsible for supervising nondeposit investment product sales activities, as well as the referral activities of bank employees not authorized to sell these products. Personnel responsible for managing the sales programs for these products should have supervisory experience and training equivalent to that required of a general securities principal, as required by the NASD for brokerdealers. Supervisory personnel should be responsible for the bank's compliance with policies and procedures on nondeposit investment products, applicable laws and regulations, and the interagency statement. When sales of these products are conducted by a third party, supervisory personnel should be responsible for monitoring compliance with the agreement between the bank and the third party, as well as compliance with the interagency statement, particularly the guideline calling for nondeposit investment product sales to be separate and distinct from the deposit activities of the bank.

SUITABILITY AND SALES PRACTICES

Suitability of Recommendations

Suitability refers to the matching of customer financial means and investment objectives with a suitable product. If customers are placed into unsuitable investments, the resulting loss of consumer confidence could have detrimental effects on the bank's reputation. Many first-time investors may not fully understand the risks associated with nondeposit investment products and may assume that the bank is responsible for the preservation of the principal of their investment.

Banks that sell nondeposit investment products directly to customers should develop detailed policies and procedures addressing the suitability of investment recommendations and related recordkeeping requirements. Sales personnel that recommend nondeposit investment products to customers should have reasonable grounds for believing that the recommended products are suitable for the particular customer on the basis of information he or she has provided. A reasonable effort must be made to obtain, record, and update information concerning the customer's financial profile (for example, tax status, other investments, income), investment objectives, and other information necessary to make recommendations.

In determining whether sales personnel are meeting their suitability responsibilities, examiners should review the practices for conformance with the bank's policies and procedures. The examiner's review should include a sample of customer files to determine the extent of customer information collected, recorded, and updated (for subsequent purchases) and should determine whether investment recommendations appear unsuitable in light of this information.

Nondeposit investment product sales programs conducted by third-party broker-dealers are subject to the NASD's suitability and other sales practice rules. To avoid duplicating NASD examination efforts, examiners should rely on the NASD's most recent sales practice review of the third party, when available. If an NASD review has not been completed within the last two years, Reserve Banks should consult with Board staff to determine an appropriate examination scope for suitability compliance before proceeding further.

Sales Practices and Customer Complaints

Banks should have policies and procedures that address undesirable practices by sales personnel, such as practices to generate additional commission income for the employee by churning or switching accounts from one product to another. Banks should have policies and procedures for handling customer complaints related to nondeposit investment products. The process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. The merits and circumstances of each complaint (including

all documentation relating to the transaction) should be considered when determining the proper form of resolution. Reasonable time-frames should be established for addressing complaints.

COMPENSATION

Incentive compensation programs specifically related to the sale of nondeposit investment products may include sales commissions, limited fees for referring prospective customers to an authorized sales representative, and nonmonetary compensation (prizes, awards, and gifts). Compensation that is paid by unaffiliated third parties (for example, mutual fund distributors) to bank staff must be approved in writing by bank management, be consistent with the bank's written internal code of conduct for the acceptance of remuneration from third parties, and be consistent with the proscriptions of the Bank Bribery Act (18 USC 215) and the banking agencies' implementing guidelines to that act. (See SR-87-36, "Bank Bribery Act Guidelines," October 30, 1987.) Compensation policies should establish appropriate limits on the extent of compensation that may be paid to banking organization staff by unaffiliated third parties.

Incentive compensation programs must not be structured in such a way that they result in unsuitable investment recommendations or sales to customers. In addition, if sales personnel sell both deposit and nondeposit products, similar financial incentives should be in place for sales of both types of products. A compensation program that offers significantly higher remuneration for selling a specific product (such as a proprietary mutual fund) may be inappropriate if it results in unsuitable recommendations to customers. A compensation program that is intended to provide remuneration for a group of bank employees (such as a branch or department) is permissible as long as the program is based on the group's overall performance in meeting bank objectives for a broad variety of bank services and products and not on the volume of sales of nondeposit investment products.

Individual bank employees, such as tellers, may receive a one-time nominal fee of a fixed-dollar amount for referring customers to authorized sales personnel to discuss nondeposit investment products. However, the payment of

the fee should not depend on whether the referral results in a transaction. Nonmonetary compensation to bank employees for referrals should be similarly structured. Auditors and compliance personnel should not participate in incentive compensation programs that are directly related to the results of nondeposit investment product sales programs.

COMPLIANCE

Banks must develop and maintain written policies and procedures that effectively monitor and assess compliance with the interagency statement and other applicable laws and regulations and that ensure appropriate follow-up to correct identified deficiencies. Compliance programs should be independent of sales activities with respect to scheduling, compensation, and performance evaluations. Compliance findings should periodically be reported to the bank's board of directors or a designated committee of the board as part of the institution's ongoing oversight of nondeposit investment product activities. Compliance personnel should have appropriate training and experience with nondeposit investment product sales programs, applicable laws and regulations, and the interagency statement.

Banks should institute compliance programs for nondeposit investment products that are similar to those of securities broker-dealers. This includes a review of new accounts and a periodic review of transactions in existing accounts to identify any potentially abusive practices, such as unsuitable recommendations, churning, or switching. Compliance personnel should also oversee the prompt resolution of customer complaints and review complaint logs for questionable sales practices. Managementinformation-system reports on early redemptions and sales patterns for specific sales representatives and products should also be used by compliance personnel to identify any potentially abusive practices. In addition, the referral activities of bank personnel should be reviewed to ensure that they conform to the guidelines in the interagency statement.

When nondeposit investment products are sold by third parties on bank premises, the bank's compliance program should provide for oversight of the third party's compliance with its agreement with the bank, including its conformance to the disclosure and separate-facilities

guidelines of the interagency statement. The results of this oversight should be reported to the board of directors or a designated committee of the board. Management should obtain the third party's commitment to promptly correct identified problems. Proper follow-up by the bank's compliance personnel should verify the third party's corrective actions.

AUDITS

Audit personnel should be responsible for assessing the effectiveness of the institution's compliance function and overall management of the nondeposit investment product sales program. The scope and frequency of audit reviews of nondeposit investment product activities will depend on the complexity and sales volume of a sales program and on whether there are any indications of potential or actual problems. Audits should cover all of the issues discussed in the interagency statement. Internal audit staff should be familiar with nondeposit investment products and receive ongoing training. Findings should be reported to the board of directors or to a designated committee of the board, and proper follow-up should be performed. Audit activities with respect to third parties should include a review of their compliance function and the effectiveness of the bank's oversight of the third party's activities.

Retail Sales of Nondeposit Investment Products Examination Objectives

Effective date May 1996

Section 4170.2

- To determine that the banking organization has taken appropriate measures to ensure that retail customers clearly understand the differences between insured deposits and nondeposit investment products and that they receive the minimum disclosures both orally during sales presentations (including telemarketing) and in writing.
- To assess the adequacy of the institution's policies and procedures, sales practices, and oversight by management and the board of directors to ensure an operating environment that fosters customer protection in all facets of the sales program.
- To ensure that the sales program is conducted in a safe and sound manner that is in compliance with the interagency statement, Federal Reserve guidelines, regulations, and applicable laws.
- 4. To assess the effectiveness of the institution's compliance and audit programs for non-deposit investment product operations.
- 5. To obtain commitments for corrective action when policies, procedures, practices, or management oversight is deficient or when the institution has failed to comply with the interagency statement or applicable laws and regulations.

Retail Sales of Nondeposit Investment Products

Examination Procedures

Effective date September 1992

Section 4170.3

- Verify through the minutes of the board of directors that the directors have approved the sale of uninsured annuities, reviewed, and approved the choice of an underwriter in the past year.
- 2. Determine if the bank adequately evaluates the underwriter's financial condition at least annually and regularly reviews the credit ratings assigned to the underwriter by at least two independent agencies evaluating annuity underwriters. (Banks engaged in the sale of annuities are expected to sell only products of financially secure underwriters and to make current ratings of the underwriter available to an investor when purchasing an uninsured annuity.)
- Verify that the bank does not sell uninsured annuities at teller windows or other areas where retail deposits are routinely accepted.
- Assess the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposittaking function by ensuring that—
 - a. the contract, advertising, and all related documents disclose prominently in bold print that the annuities are not deposits or obligations of an insured depository institution and are not insured by the Federal Deposit Insurance Corporation;
 - advertisements do not contain words, such as "deposit," "CD," etc., that could lead an investor to believe an annuity is an insured deposit instrument;
 - c. the obligor of the annuity contract is prominently disclosed and names or logos of the insured bank are not used in a way that might suggest the insured bank is the obligor:
 - d. adequate verbal disclosures are made during telemarketing contacts and at the time of sale:
 - e. retail deposit-taking employees of the insured depository institution are not engaged in the promotion or sale of uninsured annuities;

- f. information on uninsured annuities is not contained in retail deposit statements of customers (either as advertising on deposit statements or as "junk mail" stuffers included with deposit statements) or in the immediate retail deposit-taking area;
- g. account information on annuities owned by customers is not included on insured deposit statements; and
- h. officer or employee remuneration associated with selling annuities is limited to reasonable levels in relation to the individual's salary. (As a guideline in reviewing remuneration, see the Board's policy statement on disposition of credit life insurance, as discussed in the Consumer Credit, Examination Procedures, section of this manual.)
- 5. If the bank allows a third-party entity to market annuities on depository-institution premises, assess the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposittaking function by determining that—
 - a. the bank has ensured that the third-party company is properly registered or licensed to conduct this activity,
 - b. bank personnel are not involved in sales activities conducted by the third party,
 - c. desks or offices used to market or sell annuities are separate and distinctly identified as being used by an outside party, and
 - d. bank personnel do not normally use desks or offices used by a third party for annuities sales.
- 6. Encourage the bank to obtain a signed statement from the customer indicating that the customer understands that the annuity is not a deposit or any other obligation of the bank, that the bank is only acting as an agent for the insurance company (underwriter), and that the annuity is not FDIC-insured.